# *United States Court of Appeals for the Second Circuit*

# APPENDIX

# 77-6010/11

UNITED STATES COURT OF APPEALS
FILED
JAN 20 1977
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SECOND CIRCUIT

ORIGINAL
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# UNITED STATES COURT OF APPEALS
*for the*
# SECOND CIRCUIT

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs-Appellants,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT II, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

- - - - - - - - - - - - - - - - - - - - - - - - - - - - - - - - - - - - -

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS, INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs-Appellants,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

## JOINT APPENDIX
(Volume II of II - Pages A-417 - A-825)

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(6038A)

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# LETTER OF SHEARSON HAYDEN STONE, INC.

A-417

SHEARSON HAYDEN STONE INC.

Western Union International Plaza
New York, N.Y. 10004
(212) 623-8000

Member New York, American and other Principal Exchanges

November 1, 1976

Commodity Futures Trading Commission
Attention: Secretariat
2033 "K" Street N.W.
Washington D.C. 20581

Gentlemen:

We are responding to the request for comments issued by the Commission on October 8, 1976.

Shearson, has on many occassions, stressed to the Commission, its strong belief that there are legitimate business and speculative uses for commodity options and that these options are a valid and useful business tool in offsetting risk by a user or purchaser of various commodities. We agree with the proposal, that the best method of providing a market for hedgers and speculators - is an option market on a recognized domestic exchange - but, in anticipation of normal delays in the formation of such markets, the alternative "OTC market" in commodities options should be allowed to develop - including the recognition of the ICCH as an equivalent to a domestic clearing organization. It is with this background that Shearson reviewed the proposed rules and regulations and submits the following comments:

The segregation proposal of Section 32.6 results in "double segregation" and imposes a financial strain on many of the smaller firms. It is hoped that the commission could develop an alternative course of action - with the ICCH - wherein physical custody of funds would be deposited in the U.S. through arrangements with large commercial banks that deal in securities and foreign currencies.

It is understandable that due to current interest rate variations, grantors on the ICCH are not anxious to segregate funds in the U.S. However, it is hoped that conciliatory meetings with London officials can result in alternative courses of action that might be less onerous and still provide that option customers be assured that the assets which they put up to purchase the option will be safe during the term of the option. The Commission should be cognizant of the fact, that segregation of premiums is by itself, no guarantee as to performance on the customer's equity, since the premium is the one item which holds no value, but rather moves toward zero value as time passes.

Section 32.6 includes the provision that all assets received from customers as payment of the purchase price be segregated and to treat such assets as belonging to option customers.

Shortly, Shearson intends to retail commodity options directly to Shearson clients through our vast network of sales branches. We intend to market this product in a manner similar to our futures marketing program. It is our practice to "charge" a reasonable commission for our services to our clients. In our commodity option program, it is planned to charge a reasonable commission of approximately $150. per transaction for our services. In no other area of the securities industry, are we required to segregate commissions paid to us by our customers. And we do not understand what the segregation of commissions accomplishes in this regard. Segregation of this premium does not in any way guarantee performance on a customer's unrealized profit above the premium paid for the transactions. Indeed, this provision might well be counter-productive in that it might induce-unscrupulous brokers-in order to generate cash flow - to the premature exercise of options.

Commissions should not be included in the segregation of option customers assets.

Many of the disclosure requirements under Section 32.5 of the rules - as proposed - are substantive and we agree that customers should be made aware of his cost by virtue of a disclosure statement. However, it should be pointed out, that-due to the commodity option markets fluctuations - the FCM should not be placed in a position of making misrepresentations based upon a "good faith estimate" made in advance of a market move. So long as the percentages remain unchanged, these estimates should remain valid for additional purchases by the same client.

In the proposed regulation the prospective option customer should be furnished with a summary disclosure statement by the person soliciting the order.

SHEARSON HAYDEN STONE INC.

Therefore, the statement, "not less than 24 hours prior to entry into the transaction," needs further clarification. Does the word entry in this regard mean "placing of the order" or"each order thereafter"or"execution of the order!" It is of major importance that these items be clearly defined for the F.C.M.

In any commodity option transaction, we propose that each customer obtain from his dealer, a hypothetical estimated total cost - in dollars - displayed on the statement clearly detailing the items that makeup this cost. "Strike price" "required market moves" - should be presented as an example only. What we should provide our customers with, is a - clear - concise - explanation of how option transactions are effected, as well as, how profits many be derived from such transactions.

In conclusion, we must reiterate the position we initially took in this matter; which is, that the most desirable option markets would be those that would be provided by domestic exchanges. Furthermore, we believe, that those foreign exchanges clearing through the ICCH be recognized and that an "OTC" market in options be permitted. However, they should be stringently controlled until such time as domestic exchanges, do in fact, begin to make active markets in options.

The investing public is not served by imposing on FCM's some of the unreasonable segregation regulations and many of the impractical disclosure requirements that are included in the interim rules.

This firm stands ready, as always, to cooperate with the Commission in any way possible in trying to establish reasonable rules and regulations with regards to commodity options transactions which best protects the investing public.

Very truly yours,

Max Leibler

Max Leibler, Vice President
Director - Commodity Options

ML:psm

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X C

(1) Options

# LETTER OF SPENGLER CARLSON GUBAR CHURCHILL & BRODSKY

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TELEPHONE
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November 4, 1976

Re: Proposed Interim Regu-
lation 41 F.R. 44560
(October 8, 1976)

Commodity Futures Trading Commission
2033 K. Street, N.W.
Washington, D. C. 20581

RECEIVED
NOV 15 [illegible]
[illegible] of General Counsel
CFTC

Gentlemen:

This letter sets forth comments regarding the proposed interim rules relating to commodity options which are set forth in 41 F.R. 44560 (October 8, 1976). Since its inception, the Commodity Futures Trading Commission ("CFTC") has been wrestling with the questions whether and how to regulate transactions in commodity options. Although the questions were resolved, and such transactions are to be regulated and not prohibited; nevertheless, the economic effect of the interim rules would result in the cessation of offering commodity options, especially London options, in the United States.

The CFTC has been concerned about the sales practices employed in the offer and sale of London options. However, the CFTC has not been entirely successful in prohibiting option dealers from continuing their alleged violative practices on the grounds of the present fraud regulations. If the concern is that interim regulations are the only way to regulate and prevent the continuation of such practices, the regulations should be specifically directed to the supposed abuses, rather than having a draconian effect on all dealers.

The following are specific comments to the proposed interim rules:

1. Regulation 32.6 - Segregation. It appears that one purpose of this regulation is to prevent "naked

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options" by insuring that the customer's funds are protected during the period of the option. However, this regulation may cause the reverse effect - in that the dealer is forced to find funds from other sources to purchase the option. Moreover, compliance with this regulation would restrict the number of customer transactions that any dealer may engage in because of the financial restrictions, or provide an incentive for the dealer to churn the customer's account. Such restriction could have an anti-manipulative market effect. Moreover, this regulation would have an anti-competitive effect in that large diversified firms would be at an advantage over the smaller firm which specializes in commodity options.

It is suggested that the item which should be segregated is not the customer's funds, rather the option which is purchased for the customer. A system could easily be developed whereby the customer's confirmation identifies the option purchased for him. The identification would be given to all parties in the chain of the transaction, including the commodities firm in London, any other executing U.S. firm and the ICCH. This could be done without revealing the customer's name through a system of identification numbers. However, no dealer within the chain would have the right to encumber, pledge or otherwise create a lien on the customer's option. A regulation could be developed following the precedents of Rule ~~15~~c3-3 under the Securities Exchange Act of 1934. It is submitted that all parties would be cooperative in instituting such a procedure.

It is unclear whether the segregation regulation would apply when the customer's dealer purchases the option through another U.S. dealer, with the latter dealer treating the customer's dealer as its customer under some form of omnibus account. In such a situation, would both dealers have to segregate the purchase price in accordance with the proposed regulation?

Assuming that the segregation principles have some merit, the regulation should extend only to the option price. Many firms which transact London options do not engage in any other business activities. Their gross income comes solely from the sale of London options.

It makes no business sense for these firms to segregate their entire gross income. The sales force must be paid regularly, as well as the other expenses, e.g. rent, telephone, electricity, printing. Considering the proposed segregation rules and the proposed financial responsibility rules, it is economically impossible that these firms would continue in operation after the effective date of the interim rules. The CFTC should attempt to establish regulations which permit the breaking of the option price out from the purchase price, rather than abrogating its statutory mandate behind the excuse of "difficulty of defining" these terms.

2. Regulation 32.5 - Disclosure. Proposed Regulation 32.5 states that it would apply to "any commodity transaction". A literal reading would hold that it applies to each and every transaction between a dealer and its customer. For example, should a dealer have a transaction on consecutive days with a customer, twenty-four hours prior to the entry of each order the disclosure would have to be made to the customer. Considering the nature of the disclosure and the required statements, the disclosure would be more effective if only used prior to the first transaction by a customer with a dealer.

It is also suggested that the disclosure be coupled with a procedure for opening new accounts in order that the dealer "know its customer". The proposed disclosures only go from the dealer to the customer, and not vice versa. The more effective method would be to establish a procedure whereby prior to a dealer entering a transaction on behalf of a customer the dealer would receive sufficient information regarding the customer. Accompanying the confirmation would be any remaining disclosure information coupled with a limited right of rescission.

The specific statements set forth in Section (a)(4) and (5) to the Regulation would in the long run benefit only the dealer, and perhaps be detrimental to the customer. The customers will consider these legends similar to the legends required on cigarettes. For example, a dealer could point to these legends in defense of a claim by a customer that he was not fully apprised about a particular transaction. Perhaps, the legend should be shortened to "caution, trading in commodity options may be hazardous to your financial condition".

Breaking down the elements comprising the purchase price will be of no benefit to anyone. The customer's concern is whether he is receiving the best execution he can, i.e., obtain a lower purchase price for the option at a different firm. The customer does not care what elements comprise the cost, his concern is his total cost. If the CFTC is concerned about mark-ups, perhaps it should make a study and develop a mark-up policy similar to that done by the NASD.

3. Existing Options. The text accompanying the proposals states that in order to avoid any undue hardship the implementation of the regulatory program will be phased in gradually so that commodity option transactions lawfully entered into prior to the effective date will not be affected. As mentioned herein, the effect of the interim regulations would be to close down dealers which transact business solely in commodity options. There would be no incentive for them to continue business. In this event, the CFTC should consider procedures whereby it would accept from these dealers their records as to open options and thereafter service the options for the customers.

4. Hearings. The proposed regulations differ greatly from earlier suggestions and recommendations. Moreover, they are quite technical and difficult to comprehend fully. It is suggested that the effectiveness of the interim regulations be postponed pending public hearings at which time the CFTC could explain the reasons behind the regulations, how they will work in practice, whether the suggested alternative to the segregation rules would be feasible, and how firms which would be forced out of business could turn over their open options to the CFTC for processing.

Should you desire any further information regarding the comments herein, please feel free to contact the undersigned.

Very truly yours,

Bruce A

BAR:ls

## LETTER OF ROMNEY, NELSON & CASSITY

A-424

Romney, Nelson & Cassity
Attorneys and Counselors at Law

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ROMNEY & NELSON 1922 - 1971
VERNON ROMNEY 1922 - 1976

OF COUNSEL: KEITH L. ROMNEY

November 4, 1976

John Rainbolt
Chairman Option Trading Rules Committee
Commodity Futures Trading Commission
1120 Connecticut Avenue N.W.
Washington D.C. 20036

Re: Comments on Proposed Interim Rules for Commodity Options

Dear Mr. Rainbolt:

Our law firm represents a company engaged in commodity options transactions. We make the following comments on the proposed interim regulations.

1. Section 32.3 Unlawful Commodity Option Transactions. Section 32.3 should be changed so as to make it plain whether a commodity options dealer registering as a futures commission merchant will also have to meet the specific requirements of other futures commissions merchants. I note that recently the Commission has proposed new regulations for futures commission merchants. Hence, the CFTC should specifically state whether commodity options dealers registered as futures commission merchants will be subject to the regulations of other futures commission merchants as well as the regulations that will be proposed from time to time specifically for persons engaged in commodity options transactions. We also suggest that associated persons be allowed to accept money as well as future commissions merchants. Further, Section 32.3(c) is not very helpful in determining whether a commodity options dealer registered as a futures commission merchant should also register as a commodity trading advisor. Admittedly, paragraph (c) is practically identical with Commodity Futures Trading Act of 1974. The problem is, however, that a commodity options dealer does not fit comfortably within any of the pigeonhole definitions of futures commission merchant or commodity advisor contained in the Act. Rather, the Act allows the CFTC to promulgate regulations for

those engaged in commodity options transactions. The Commission has determined that commodity options dealers should register as FCM's because the public is familiar with the term FCM. This does not mean however, that the CFTC could not require all commodity options dealers to register only as Futures Commission Merchants and not as Commodity Advisors. If this suggestion is rejected, it will be difficult for any person engaged in commodity options transactions to determine whether he should register as a Commodity Advisor.

2. Section 32.5 Disclosure. It is desirable to have commodity options customers receive a disclosure statement similar to the one proposed by Regulation 32.5. We make the following suggestions for the sake of clarity and brevity. The regulation does not state whether the statement required in 32.5 (a)(5) must be contained on the front page. Further, the statement called for in (5) is redundant in light of the disclosure statement required in paragraph (4).

3. Section 32.6 Segregation. Assuming, the CFTC is going to require segregation of accounts, we make the following suggestions. First, the CFTC should plainly state whether the segregated accounts are to be escrow accounts or trust accounts. The phrase "shall treat and deal with such money, securities and properties as belonging to such option customer," is not very helpful in determining what rights each party has to the account. For example, it is not clear who is to receive the interest from the monies deposited in a bank or trust company. Paragraph (e) states that the person who invests the money may receive the interest but it does not state whether the original person who accepts the money and deposits in the customer bank may receive the interest. The regulations would be simpler and the customers would still be protected if the CFTC would state that persons receiving money must deposit the funds in a trust account for their customers until the option expires or until the option is exercised and the customer has received all of his rights under the option. The second problem with Section 32.6 is that it does not clearly state who can do the investing. Paragraph (b) only implies that banks and not the persons receiving the monies can do the investing. Further,

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paragraphs (c) and (d) do not make a lot of sense if the only investments that can be made are those in United States guaranteed obligations. Finally, we believe that requiring the segregation of funds is a harsh method of protecting the customer, particularly in light of the double segregation requirements imposed on those who deal in London Commodity Options transactions. Further it is hardly the least anti-competitive means of accomplishing the desirable result, that of protecting the customer.

4. Section 32.7 Books and Record Keeping. Paragraph (a) assumes that the only advertising material furnished the customers or prospective customers is that of the print media. We suggest that the paragraph be revised to instruct those engaged in commodity options transactions whether they must retain records of advertising placed in the broadcast media.

Sincerely,

ROMNEY, NELSON & CASSITY

DONN E. CASSITY

DEC/klb

## LETTER OF FIRST COMMODITY CORPORATION OF BOSTON

X 07427

A-427

First Commodity
Corporation of Boston

Commodity Futures Trading
Commission
Attention: Secretariat
2033 K. Street, N.W.
Washington, D.C. 20581

Gentlemen:

I am writing in response to your request for comments on proposed regulations which appeared in the F.R., Vol. 41, No. 197, Friday, October 8, 1976.

Due to several past problems in the industry, we welcome CFTC action, and find most of the proposed regulations to have considerable merit-particularly the requirement for option dealers to register as FCM's, and mandatory financial requirements. However, there are certain points which are not clearly defined, and others which seem unpractical or unrealistic. I will address my comments only to those few problem areas:

(1) Double Segregation

As we know, the only commodity options of note that are traded in this country are London options of the LME and ICCH. I realize that the business practices of these organizations do not parallel that of U.S. exchanges, but that is not a reason for questioning their rationale and solvency. It need not be restated that these British institutions have considerable experience in the operation of commodity markets, and their solvency should not be in question. To seal off the American public from such investments would indeed seem drastic, and unjustified in light of our international commitments to free trade. What would the CFTC say if foreign governments required that their citizens' equities in U.S. markets be segregated in their currency, or securities guaranteed by their Treasuries.

On the surface, I do not think it reasonable to expect foreign organizations be required to segregate premiums in the U.S. Segregation of premiums is no guarantee as to performance on the customer's equity in any event. The premium is in fact the one item which holds no value, but rather moves toward zero value as time passes.

International Commodity Brokers/Dealers
19 Congress Street
Boston, Massachusetts 02109
Telephone (617) 523-1138

It is understandable that grantors on the ICCH do not desire to segregate monies in the U.S. which can at best only return U.S. Treasury interest rates--well below those prevailing in England. The proposed regulations state that "The Commission wishes to emphasize that 32.6 requires that assets must be segregated in the United States, so that such assets will not be subject to the attachment or other laws or requirements of any other nation." Taking such a stance with our oldest trading partner, the United Kingdom, can only create considerable animosity. If other nations took this approach to American commodity and security markets, the bottom would quickly fall out. I would proffer that the CFTC allow the ICCH to continue holding equities and premiums abroad, or in vehicles other than U.S. dollars or Treasury Bills. It is not reasonable for a foreign exchange to be required to help finance the U.S. debt. If physical custody of the funds is to be in the U.S., this could be worked out through a large commercial bank which deals in and holds foreign currencies and securities in this country.

Obviously, the only complete protection would be segregation of equities by the LME and ICCH. However, the mechanics of this are beyond the scope of this firm, and I trust the CFTC is working on this.

In any event, should the CFTC not recognize this foreign segregation the next point to question is the requirement for segregation of the entire retail cost of an option. I can think of no known parallel to this approach. Any firm in the financial community must generate a cash flow to conduct business. If the broker is denied use of commissions, then he must derive income from float on funds--but by denying him use of his operating capital, he must borrow funds at a higher rate typically than any possible return on government securities put up for segregation requirements. This introduces another significant cost to the business--one which the CFTC must be aware will ultimately be born by the consumer. Segregation of this premium does not in any way guarantee performance on a customer's unrealized profit above the premium paid. In fact, the CFTC is inducing brokers to exercise options early to release operating income--another obvious detriment to the consumer. In this light, segregation of the premium is not reasonable. If any portion need be segregated, it should be strictly limited to the broker's cost. This will still allow a considerable pool of capital for payment of customer equities.

(2) Financial Requirements

(a) I agree that $50,000 should be the minimum adjusted working capital for an FCM; however, not just those dealing in options. but all FCM's. The CFTC claims "for futures commission merchants engaged in options activity (a higher level) is necessary to provide a cushion against losses which could arise as a result of any number of factors, such as dishonesty, incompetence, insufficient or inadequate segregation." All these factors, in addition to far greater market risk, apply to FCM's dealing in futures. If this level is not raised to $50,000 in all cases it would indeed appear discriminatory against persons dealing in options--and I see no economic justification for such differentiation.

(b) Unfortunately, Section 32 does nothing to clarify the safety factors relating to commodity options. First Commodity, unlike most dealers in options, chose to be an FCM long before any hint of mandatory registration was raised. We have observed inconsistent application of financial requirements and were led to believe these proposed regulations would provide clarification, yet none is given. In particular:

(1) Would futures hedges against options be subject to the 1/2 of 1% safety factor on option positions. This 1/2 of 1% haircut is specifically related to "open contracts." Open contracts as defined in the regulations (Section 1.2(t)) are those "....which have not been fulfilled by delivery nor offset by other contracts of sale or purchase in the same commodity or contract month." As futures hedges against options are in fact offset, they would not in my opinion, qualify as open contracts and no haircut should apply.

(2) Will equities on deposit with clearing broker in non-regulated accounts be treated as unsecured receivables and subject to a 5% haircut? This would not seem reasonable since segregated equities are not subject to any haircut. Even under the proposed double segregation requirements for premium, there is no provision for segregation of unrealized profit or losses in options or futures hedges against them. My opinion is that the equities with clearing brokers should not be subject to any haircuts and the equities due customers in non-regulated commodities (part of aggregate indebtedness) should be subject to the 5% haircut but only after reducing the total aggregate indebtedness for the total premiums in segregation. This would result in an adequate amount of customer protection and be consistent with the approach taken in regulated futures.

Again, I feel it imperative to stress the importance of clarification on these points. If the CFTC in fact intends to enforce a 5% haircut on equities with clearing brokers and another 5% haircut on customer equities on London options and futures, without offset for premiums in segregation, then the $50,000 requirement is meaningless and FCM's dealing in options may never be able to insure adequate working capital to fulfill such requirements. If customers are in profitable options, and our customers have been profitable on the whole, and the markets moved in the customer's favor, where would the additional capital appear from to cover the 10% total haircut? This requirement would place the interests of the client in direct opposition to that of the broker--a condition the CFTC should not foster by law.

(3) Disclosure

(a) In Section 32.5, (5)(b), a requirement to disclose estimated purchase price (factors making it up) strike price, and break even price are detailed. All these elements are contingent on market orders which are often filled at a premium and strike price well above or below those anticipated. I think it would make more sense to simply provide an estimated total cost in dollars and then a % figure to show the items that make up this cost. Strike price and required market move should be presented as an example (at current market prices) only, as the FCM has no way to control market fluctuations and should not be placed in a position of making misrepresentations, and have a debate follow as to how good an "estimate" was provided. Such summary disclosures and percentages could be included in large capital letters as part of the new account agreement form and remain valid for additional purchases by the same client, as long as the percentages remained unchanged. Additional price disclosures for each option purchased would unnecessarily increase an already heavy load of paperwork required of our firm by the government.

(b) The CFTC should be aware that when dealing with combined option/future orders (i.e., Put/Long, Call/Short, Double/Long. Double/Short, Double/Long/Short) these presentations and estimates will not be as simple as implied in the regulations because so many more variables come into play.

(c) If the suggestion in (a) above is not adopted, then there is a problem that must be clarified. The regulations call for "each prospective option customer shall be furnished with a summary disclosure statement by the person soliciting the order: therefore, not less than 24 hours prior to entry into the commodity option transaction." I assume that "entry" here means placing of the order--not execution. It is obvious that these statements must be provided by mail. Can FCM's assume to have fulfilled this requirement by mailing such statements as per postal service guidelines (1 day delivery in 600 miles, 3 day delivery nationwide). For example, if the statement is mailed to a nearby city 2 days prior to order placement, may the order then be placed (assuming customer funds are in house) without the FCM assuming the burden of confirming delivery? And if delivery must be confirmed, how shall that be done? It is important that these items be clearly defined so as to avoid increased potential for reparations--a burden the CFTC and the industry can ill afford to encourage through hazy regulation.

I should also mention that the whole CFTC approach on options seems to be one whereby the option is held solely as a long term speculation of a market move in one direction. In practice, the option may well be serving a completely different purpose--that of a hedge against anticipated futures trading. As the public becomes more sophisticated, the incidence of this can only increase, and disclosure of how this option will function becomes fairly complex. These points are not raised to confuse the issue, but simply to alert the Commission of different situations which will arise through the normal course of business.

(4) Recordkeeping

(a) In Section 3217 (a) of the proposed regulations, it calls for FCM's to keep "Such records.....disclosure statements,..... and all other literature, or written advice distributed.....or prospective option customers." And, "the true name and address of each commodity option customer or prospective commodity option customer solicited." I don't know what you mean by prospective customer (addresses of bulk mailings, telephone contact, responses to ads?), but to have such a requirement for five years would be an undue burden and serve no purpose as non-customers could not be a basis of reparation. Such a provision is not in fact enforceable, and as such, detracts from the overall reasonableness of the Act. I know of no such provision for keeping records on prospective customers in regulated futures or any other investment or speculation area.

(b) Section 32.7 (b) requires FCM's to "keep a record in permanent form which shall show the true name and address of each maker, underwriter, issuer, or other person who assumes or purports to assume any financial responsibility for the fulfillment of any commodity option transaction..." If I interpret this literally, it means that it would be necessary to determine who the granting broker (or their grantor's client) is on the ICCH or LME. This is not practical or possible to my knowledge.

## (5) Customer Insurance

One of the areas covered by the Act called for the CFTC study of client insurance in the futures industry similar to FDIC in banking and SPIC in securities. Such insurance against losses would go a long way toward relieving the threats to clients of improper actions or insolvency of firms. I must admit that I have not followed progress in this area, except we provided the CFTC economists with information to aid in a study for such insurance. This is one area that should be stressed, and proposed regulation should make provision for the certain eventual availability of such coverage.

Respectfully,

Don R. Schleicher
President

DRS:sr

# LETTER OF PHELAN AND PHELAN

A-432

PHELAN AND PHELAN
ATTORNEYS AT LAW
111 WEST WASHINGTON STREET
CHICAGO, ILLINOIS 60602
TELEPHONE: (312) 782-5600

WILLIAM M. PHELAN
JOSEPH F. PHELAN

October 27, 1976

Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Attention: Secretariat

Re: Commodity Options-Interim Rules

Gentlemen:

The following comments are submitted on behalf of several of my clients who are Future Commission Merchants (FCM) offering London Commodity Options to the public.

1) Proposed Segregation

The present proposal will invoke an extreme hardship on the FCM's as the proposal is essentially a double segregation, a fact recognized by the draftsmen.

The proposal recommends that all funds and securities be segregated and that no commission or profit to the FCM be removed from segregation until the option expires. The duration of time that an option contract is open compared to a futures contract, is generally much longer. This would mean that the Associated Person (AP) could not be compensated for many months after the execution of the option unless the FCM advanced the funds from its own working capital. Advancement of commissions to AP's by an FCM could effect the financial stability and working capital of the FCM.

AP's would tend to sell options with early expiration dates to obtain their commissions at an early date and not fully consider the best available option for their customer. As a point of interest, many FCM's have abandoned the "round turn" commission charge for an "in and out" charge, debiting the customer one-half of the commission when the position is initiated and the balance when the position is liquidated. This procedure could be adopted by the

Commission and would afford some relief to the FCM's and AP's.

The Commission should allow full credit as good segregated funds, the amounts on deposit with carrying brokers. Such procedures exist in the present segregation rules for futures. The carrying broker credit should be available to London Option dealers who are member firms in good standing of the various London Commodity Exchanges.

An increase of the minimum financial requirement of an FCM, which is presently the greater of certain safety factors and charges against working capital or $10,000.00, should be effected. A suggestion would be that the $10,000.00 figure be increased to $50,000.00 and those FCM's involved in options should be increased to $100,000.00.

An additional argument against full segregation exists within the proposed rules on disclosure which requires setting out in detail the commission charge by what name it is called. The customers will be given a full breakdown of the cost and will know the cost of the option to the FCM, so why should the excess be segregated? One of the reasons, advanced by the draftsment, for full segrega- is "....unscrupulous persons to characterize the major portion of the purchase price as a 'sales commission' and thereby tend to encourage attempts to evade the segregation requirements.", which ignores the existence of the anti-fraud section of the Act, and the fact that the customer would not be entitled to a refund of the commission in any event.

Another reason advanced for full segregation is the insolvency of FCM's. Historically, the losses have been extremely small. The Commissions records reflecting regulated customer losses due to insolvency will support this conclusion.

In summary, only the actual premium should be segregated with full credit given for deposits with carrying brokers. This position is consistent with the segregation rules presently in effect for the futures market. History has demonstrated that the segregation provisions as they presently exist, have afforded adequate customer protection. I fail to see any compelling reason to subject the options to a greater requirement than the futures.

A-434

would be available to appear before the Commission to orally express the views stated herein and to be questioned by the Commission, staff or members of the public.

Very truly yours,

William M. Phelan

William M. Phelan

WMP/my

THE LONDON COMMODITY EXCHANGE COMPANY LIMITED
REGISTERED IN LONDON · NUMBER [illegible]

DIRECTORS
A. J. P. WOODHOUSE (CHAIRMAN)
D. ST. C. [illegible] (VICE CHAIRMAN)
A. L. [illegible]
W. [illegible]
P. J. DAY
G. M. HOUGHTON
A. C. D. [illegible]
R. F. [illegible]
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PASR/LE

Commodity Futures Trading Commission,
2033, K Street,
N.W. Washington D.C. 20581
U.S.A.

1st November, 1976.

For the attention of Mr. J.V. Rainbolt II, Vice-Chairman

Dear Sirs,

COMMODITY OPTIONS

Since our letter of the 4th October, 1976, we have given further consideration to this matter in the light particularly of the proposed Rules and Regulations published in the Federal Register on 8th October, 1976, following the Commission direction dated 13th September 1976.

We were pleased to note from Mr. Rainbolt's telex of the 18th October, 1976 that the Commission has decided in principle to permit London options to continue if some acceptable format can be agreed, and we likewise remain willing to appoint representatives to a delegation to discuss this matter further in Washington or London, and this delegation would include a representative of International Commodities Clearing House Limited ("ICCH"). The impending date of 8th November, 1976 does not, however, leave very much time to conclude arrangements, and I would respectfully request that this date be extended by another fourteen days so that this matter could be usefully progressed and hopefully concluded.

Our letter of the 4th October was intended to explain how the operations of the London option markets (whose Associations form part of this Exchange) and the role of ICCH should, subject to implementation of our suggestions, provide the kind of protection which we understand the Commission desires to achieve. We [illegible] confident that, if these suggestions are pursued in further detail, it should be possible to achieve a position which provides the desired protection and at the same time does not unreasonably interfere with the established operations of the London markets.

We would first emphasise, in general terms, the position of the London option contracts, with particular reference to some of the criteria referred to in Part C of the Commission direction dated 13th September, 1976. The option contracts have been in operation for a number of years, in conjunction with the normal futures contracts on the particular market. Their particular terms have stood the test of experience and are generally regarded to be fairly balanced between the parties (the "grantor" and the "taker"). Like the futures contr themselves, they are used by the usual commercial parties with interests to and protect on world commodity futures markets. Like the futures contract the option contract enjoys the benefit of the ICCH guarantee, which of course is then applied to the futures contract created on the exercise of the option.

THE LONDON OPTION CONTRACT MARKET

I enclose a copy of the relevant current ICCH bye-laws relating to option contracts, together with the related general Regulations for ordinary futures contracts, and we draw attention briefly to certain terms which may be particularly relevant to consideration of this matter.

1. The bye-laws incorporated by reference the general Regulations of ICCH relating to ordinary futures contracts for the particular commodity (save as varied in the bye-laws) so that the option contract is similarly guaranteed. (Bye-law 1).

2. Whether a "call", "put", or "put or call" option, a premium is paid as the price for entering into the option contract which is held by the ICCH for the party entitled to it.(Bye-law 4).

3. An original deposit and further margin on the rise and fall of the futures market price for the commodity itself are payable by the Grantor of an option contract to the ICCH in the same ways as deposits and margins are paid in respect of ordinary futures contracts for the commodity. (Bye-law 5). The prompt payment of such deposits and margins is, of course, the ICCH's protection in enabling it to guarantee all contracts. As in the case of ordinary futures contracts, no notional profit (comparing the option contract price with the current futures market price at any time), is payable during the currency of a contract. Profit only arises after exercise into an ordinary futures contract and closing out under normal procedures.

4. ICCH accordingly, in the event of default in payment of deposits or margins on demand, is entitled to treat an option contract as terminated as against a defaulting party, the other contracting party accepting by novation such other party as ICCH may substitute . Upon such termination, the defaulting party forfeits the premium (which is retained by ICCH) and any difference between the option contract price and the current market price is forthwith payable to ICCH from the deposits and margins held by ICCH. (Bye-law 5).

CONTINUED/....3

5. There is no obligation upon a party to have an open futures contract for the particular commodity before entering into an option contract, but such a party can be liberated from the obligation to pay deposits and margins on an option contract upon lodging with ICCH a corresponding futures contract. (Bye-law 6).

6. Upon a declaration under an option contract (to ICCH) the option contract forthwith becomes an ordinary futures contract for the particular commodity and normal procedures for deposits / margins for sellers and buyers will apply. The declaration may be made by ICCH on behalf of a defaulting contracting party pursuant to its general Regulations. (Bye-law 7).

If any further explanation about the operations of the option contract on the London market is required, we shall be happy to supply it.

## SEGREGATION OF FUNDS

We have understood from Mr. Rainbolt's abovementioned telex and the proposed Commission commodity option rules and regulations that it is a cardinal point that any registered Futures Commission Merchant ("FCM") shall segregate from its own assets all funds or property received from an option customer as payment of the purchase price, and treat them as belonging to such customer, and it is desired that the funds and property shall be segregated (in the U.S.A.) until the option expires or is exercised and all the customer's rights under the option then satisfied (interim CFTC regulation 32.6). We welcome the request for comments and alternative proposals insofar as this regulation would be applied to option contracts on the London markets.

We note the natural desire that such customer's funds and property shall not be subject to the claims of general creditors of FCM or attachment under the laws of the U.S.A. or other countries, and that it is desired that a refund will be made to the customer during the currency of an option contract in the event of the customer exercising the option but failing to obtain satisfaction because of the insolvency of the FCM. We note that, under a proviso of the proposed regulation 32.6, a customer's funds or property may be co-mingled with those of another option customer so long as deposited at a United States bank or trust company, which acknowledges the nature of the funds or property.

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In considering how substantially the same protection can be achieved in relation to the London markets, we do not propose to comment upon the requirements upon a FCM in the U.S.A., save insofar as they impinge upon the operation of the London markets. We assume, however, that each FCM will, under U.S. law, hold each option contract for a customer, and related funds and property, in some relationship of trust, so that they will not be subject to the claims of general creditors of the FCM or indeed of other customers of the FCM. If such a position of trust is clearly established, and the policing of this aspect would, of course, be a matter for the Commission in the U.S.A., we are advised that such funds and property as passed to London for the purposes of an option contract should be recognised by English law as fixed with this trust if again there is sufficient identification. It is with this in mind that we elaborate upon the suggestion of our letter of the 4th October, 1976, namely,

1. Each FCM should (subject to qualifying according to ICCH normal criteria) become itself a member of ICCH and thus be enabled to have contracts registered and cleared in its own name, even though originally traded through a Floor Member of a London market.

2. Each FCM should have a clearly identified separate account with ICCH for all its option customer business, separate from its account or accounts for its own proprietary option business and other ordinary futures business. (The actual breakdown of this special account between individual option customers and the FCM would, of course, only be disclosed in FCM's own records, and again this would be a matter for the Commission to police in the U.S.A.). The deposits and margins and other monies held in this special option customer account would be expressly excluded (by amendment of the present Regulations) from any right of set off of ICCH in respect of any claim it may have against the FCM on its own account or on account of its other customers' ordinary futures business. The identification of the particular option business account would depend upon the particular legal status adopted in the U.S.A. (see above), but it should be possible to prevent other creditors of the FCM or other customers successfully having recourse to the funds and property held under this account. These are matters for further detailed work and necessary reference back to our members and legal advisers.

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3. In the event of the liquidation of the FCM, the ICCH would look for instructions to the liquidator or other duly authorised person, upon such identity and authority being established, for further instructions and any necessary funds in respect of outstanding contracts. Such instructions could include the transfer of all the outstanding contracts to another FCM who is a member of ICCH. ICCH would, of course, enjoy its normal rights (see above) in the event of any default in duly furnishing instructions and/or any further necessary funds, so it would be highly important for any liquidator or other authorised person to move quickly.

4. We should again point out that the premium paid as the price of an option contract would be treated by ICCH differently to the deposits and margins to be held by ICCH in the special option customer account of the FCM. As this is the price to be paid to the "grantor" of the option, ICCH's practice is to hold it in the grantor's premium account until either the option is exercised or until maturity of the option contract because no declaration is made in due time. This practice would have to continue and we trust that, on reflection, you will agree that the "premium" must be treated separately from the other funds and property of the option customer covered by the definition of "purchase price" (proposed regulation 32.1(d)).You will also appreciate that it would be quite contrary to London market practice for the "premium" (or any appropriate funds) to be held other than in London, because of the nature of the ICCH guarantee.

5. As to the criteria for a FCM becoming a member of ICCH, it is important for any candidate for membership to be a member (in one of the classes) of at least one of our Exchange markets and a member of some equivalent U.S. commodity market association/ clearing organisation.

6. We again emphasise that ICCH records are computerised and are available on a daily basis. The extent to which information could be made available to CFTC with the consent of the member concerned could be discussed.

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7. There would be a number of other matters for further detailed discussion, including the terms and period of recognition of the London markets as "foreign commodities exchange systems", the conditions under which such recognition could be suspended or revoked and information to be supplied from time to time.

We trust that we have now amplified sufficiently the suggestions submitted in our earlier letter of the 4th October 1976 which could be further defined when we have reached agreement in principle. Whilst a number of amendments to the Rules and Regulations of our exchange markets and ICCH would probably be necessary and could be adopted so long as they did not alter materially the long established and accepted practices of the London markets, reference would, of course, have to be made back to the members of the markets and our legal advisers for further advice in detail. We have, however, had the benefit of general advice on the suggestions which we have now formulated further, and are, therefore, reasonably confident that appropriate provisions could be adopted.

Any changes in the practices and Rules and Regulations of the London markets and ICCH are inevitably of such significance that adequate consideration must be given to them and it is for this reason that we are willing to appoint a delegation to meet with the Commission again but feel that, in the interests of everyone, adequate further time should be allowed for resolving these matters. It is emphasised that the L.C.E. and ICCH wish the above meeting to be confined to the officially appointed L.C.E. / ICCH delegation and the C.F.T.C. as this delegation will not be in a position to discuss any changes to London Regulations or Procedures which may be desired by U.S. domestic option market users or other interested parties. We need hardly emphasise again the importance to the international business community of both the U.S.A. and U.K. markets remaining viable for futures business placed on and between them.

We are again sending a copy of this letter to both the Bank of England and Lord Bridges, Minister of Commerce at the British Embassy in Washington.

Yours faithfully,

THE LONDON COMMODITY EXCHANGE COMPANY LTD.

EXECUTIVE DIRECTOR

# LETTER OF HERZOG COMMODITIES

A-441

Herzog Commodities Inc.
SUBSIDIARY OF HERZOG & CO. INC. 170 BROADWAY NEW YORK 10038 (212) 349-6010

November 1, 1976

Commodities Futures Trading Commission
2033 K Street NW
Washington, DC 20581

ATT: Secretariat

Gentlemen:

This letter is in response to chairman Bagley's request in the Federal Register, Volume 41-197, dated October 8, 1976, inviting comments on the proposed rules pertaining to commodity options.

By way of introduction, the writer is John Herzog, President of Herzog Commodities, Inc., a registered futures commission merchant who deals in commodity options. I, therefore, meet the category of "interested persons", and I ask you to please consider my comments.

Firstly, I would like to congratulate the CFTC for taking steps to regulate a growing industry.

Now, I would like to comment on a section of the proposals on which the commission has specifically requested comments, #32.6 Segregation of Capital.

We have reviewed the segregation rules in this portion of the proposals, and respectfully ask you to amend them to the extent that the option account of our firm--a registered FCM--placed on an omnibus basis with a clearing member of the ICCH, who is also a registered FCM, and therefore, under CFTC control, be considered as a satisfactory depository in the U.S. for premiums paid to us by our customers. Funds placed with a clearing member of the ICCH certainly should be considered safe for our customers.

Respectfully,

John Herzog

## AFFIDAVIT OF PETER E. AARON

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

-against-

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

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76 Civ. 5123
(WK)

AFFIDAVIT IN SUPPORT OF MOTION FOR A TEMPORARY RESTRAINING ORDER

STATE OF NEW YORK )
:ss.:
COUNTY OF NEW YORK )

PETER E. AARON being duly sworn, deposes and says:

1. I am the Special Assistant on Administrative Procedures to British American Commodity Options Corp., and am a member of the Board of Directors of the National Association of Commodity Options Dealers as well as the principal of the inactive Commodity Option Trading Adviser Firm, Wall Street Commodity Options, Ltd.

2. I submit this affidavit in support of the application of

the plaintiff herein for a Temporary Restraining Order staying the implementation of the regulations presently proposed by the Commodity Futures Trading Commission ("CFTC") to "regulate" the commodity options industry.

3. It is my sincere belief that the regulations, as presently promulgated constitute an unworkable regulatory scheme which will, if allowed to stand, end commodity option dealing in the United States by those firms presently dealing in commodity options.

4. The proposed regulatory scheme has been promulgated by the CFTC with the understanding that within the immediate future the CFTC will authorize the trading of American commodity options which trading is presently illegal. The proposed regulations regarding commodity options now being traded (through the International Commodity Clearing House and London Metal Exchange, in London) coupled with the impending CFTC's authorization to trade American commodity options is a blatant attempt by the CFTC to destroy the relatively small option dealers presently trading leaving the commodity option market exclusively to the major member firms (e.g. E.F. Hutton, Shearson Haydon Stone etc.). In essence, the position of the CFTC will lead to the demise of the small firm dealing in

commodity options, on the Nixon-Watergate era theory of, that which is large (e.g. the member firms) must survive and that which is small must perish (commodity option dealers).

5. British American was and is the first firm successfully to market London commodity options in the United States. In the interest of its customers, British American has developed computerized high quality and control books and records as well as a superior sales and research staff. The success of its client's interests in commodity options has enhanced British American's position as the first name in commodity options in the United States. Yet, for British American, as well as less successful commodity option dealers, these needless regulations make survival impossible.

6. Since its inception the CFTC has played and continues to play cat and mouse with the commodity options industry, as presently constituted, playing with the mouse before destroying it.

7. Disclosure, as initially adopted by the CFTC in regulation 32.5(a), required that a summary disclosure statement be furnished to a potential options customer at least 24 hours prior to the customers purchase of the commodity option. As re-promulgated, regulation 32.5(a) in the CFTC's own language as incorporated in their comments to the regulation says, "However, the Commission wishes to emphasize that the cption customer or prospective option customer must be furnished with the summary disclosure statement prior to the entry into a commodity

option transaction. Accordingly, persons who intend to mail summary disclosure statements should obtain assurances that the summary disclosure statement has been received by the option customer or prospective option customer before entering into a commodity option transaction".

Obviously, there is no material difference between the "prior to the transaction" requirement of the new 32.5(a) and the "24 hours prior to the transaction" request of the old 32.5(a).

The CFTC makes no provision for the customer to waive receipt of the disclosure statement. The CFTC fails, due to their lack of sophistication as regards to the commodity option industry, to consider the effects of:

a) an open order notice sent prior to a confirmation; and

b) disclosing mark ups, sales commissions, foreign service fees, etc. with the open order nature.

8. It should be noted that the information that regulates 32.5(a) requires to be disclosed prior to the transaction is impossible to know due to the fact that markets change daily.

Clearly every firm would be in violation of Regulation 32.5(a) because the information required to be disclosed thereunder, "prior to the option transaction" is not available "prior to the option transaction".

The CFTC's comments to the regulation state "In addition, as adopted, 32.5(a) eliminates the requirement that particularized price information be furnished as part of the summary disclosure statement. Rather, the summary disclosure statement shall contain (1) a brief descrip[illegible] the commodity option transactions being offered, including (i) the duration of the commodity options being offered and the total quantity and quality of the commodities which may be purchased or sold upon exercise of the options being offered or which underlie the contracts of sale for future delivery which may be purchased or sold upon exercise of such commodity options; (ii) a listing of the elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees and other charges, as well as the method by which the premium is established."

10. It is impossible for any commodity option dealer to list all of the elements comprising the purchase price to be charged the customer. For example, regarding the premium charged, British American as well as most commodity option firms does not purchase an option until a customer's funds are received. In the 5 day period between the customer order and receipt of the customers funds, a customer is virtually guaranteed a net price or gross premium (a London premium plus option dealer's mark-up). The dealer however, has no way of

knowing whether the premium price during this period will go up or down. The dealer also has no way of knowing whether the strike price of the underlying option will go up or down. Therefore, due to market fluctuations, it is impossible to accurately predict the actual mark-up or charges to the customer. During this 5 day period of time, as above described, not only is the underlying commodity due to market fluctuations subject to price changes but additionally, the exchange rate of the currency is subject to change as we are dealing with a foreign commodity, on a foreign exchange, payable in foreign currency. The commodity option dealer cannot disclose what is not knowable. This disclosure requirement is another example of the CFTC's lack of sophistication and knowledge as regards the workings of the industry and is only one example of the many reasons why extensive hearings on each and every segment of the proposed rules should have been held.

11. The CFTC's comments (sub paragraph (iii) to the regulations require disclosure of the "the service to be provided for the separate elements comprising the purchase price." I believe that this information is not only unnecessary information but the requirement itself is vague and overbroad in its ambit.

12. Sub paragraph (iv) of the CFTC's comments to regulation

requires the disclosure of 1) "the method by which the striking price is established." We believevthat disclosing this is also unnecessary because a strike price is determined by the market price. Option dealers do not mark-up striking prices. They mark-up option premiums; (emphasis added) 2) "storage and interest commissions". It is well known in the industry that all metals options have storage charges called "contango." These contango rates are standard throughout the industry and thus we believe such disclosure to be redundant. However, for the benefit of the Court and edification of the CFTC we are enclosing a copy of how to figure contango from British American's most recent market letters. This proposed disclosure requirement is yet another example of the draftman of the rules' lack of sophistication and expertise in the commodity option area. It should be embarrassing to the CFTC that such a neophite should be responsible for such a delicate task; 3) "a statement to the effect that the price of the commodity or contract of sale for future delivery underlying each commodity option transaction being offered must either rise above the striking price, or fall below the striking price, as the case may be, by an amount in excess of the sum of the premium and all other costs incurred in entering into and exercising the commodity option in order for the option customer to realize a profit on the commodity option transaction."

Due to the continual change of exchange rates between the dollar and the British pound, it is almost impossible to state the sum of money necessary in order for a customer to realize a profit. It should be noted, that it is easier for a client to contact his representative at British American to find out the current London option prices and the conversion rates for the day. Generally, the commissions charged the customer for commodity option purchases are similiar in amount regardless of the dealer used. Economic realities foster relatively standard rates of commissions, i.e. option customers purchase options from the dealer that offers the best prices; 4) "a clear explanation of the effect of any foreign currency fluctuations with respect to options which are to be executed on or through the facilities of a foreign board of trade." The effect of foreign currency fluctuations vary. The foreign currency market is a volatile entity. Sometimes the commodity market will react to a devaluation of a currency positively, at other times negatively. Accordingly it is virtually impossible to accurately and clearly explain "the effect of foreign currency fluctuations." Regulation 32.5(a) (5) requires the following boldface statement on the first page of the disclosure statement ".Because of the volatile nature of the commodities markets, the purchase of commodity options are not suitable for any member of the public. A person should not purchase a commodity option unless he is prepared to sustain a total loss of the purchase price of the commodity option. Scuh transactions should be entered into only by persons who are aware of the potential for loss and who understand the nature and extent of their rights and obligations. These commodity options have not been approved or disapproved by the Commodity Futures Trading Commission nor has the Commission passed upon the accuracy or adequacy of this statement. Any representation to the contrary is a violation of the Commodity Exchange Act and the regulations." The commodity futures industry has no such requirement. Commodity futures are far more financially dangerous that commodity options. For example, if I as a customer purchased a London sugar option for $3,500.00, the maximum amount of money I risk is $3,500.00. If I purchased the same dollar amount of commodity futures my $3,500.00 would represent only a partial payment for the futures with the remainder of the futures price held on margin. Because of the margin factor in futures speculation, the speculator has a higher risk factor - from $3,500.00 to approximately 9 times that amount. Futures are a more dangerous and speculative investment than options. Yet, the CFTC would require disclosure for commodity option purchases and requires no such disclosure for futures purchases which are far more risky. By mandating such disclosure the CFTC has displayed a patent preference for the futures market to the detriment of the commodity option market. It appears that the regulatory scheme proposed by the CFTC has as its paramount purpose, the destruction of the commodity options market.

14. Regulation 32.5(d), as adopted, requires that confirmation statements be delivered to all option customers after the execution of each option transaction, and that not more than 24 hours after the execution of a commodity option transaction, a commodity option customer must be furnished, by mail or other generally accepted means of communication, with a written confirmation statement which contains "the actual amount of the purchase price, including a separate listing of the premium, mark-ups on the premium, costs, fees and other charges." Providing such information within 24 hours after the execution of the option purchase is impossible as such information is unavailable within 24 hours of the commodity option purchase. For example, at one time Shearson Haydon Stone was clearing for British American. There was a backlog on purchase and sales in Shearson's back office for three weeks. Had these regulations been in effect, British could not have complied with them, through no fault of its own. The exigencies of the market are such, that delays in obtaining clearing information are not uncommon. I believe that disclosure of mark-ups is unnecessary. Our sister industry on prinicipal trades requires no disclosure of mark-up. Why then should British American disclose mark-up when in essence British is selling options to customers on a principal basis? Why should commodity options be singled out in this prejudicial manner? Some will say that an option transaction by British American is not a "risk transaction".

For example, in the securities market, if a security dealer purchases a security at five dollars and the next day resells the security at five and one-half dollars to a customer he does not have to disclose his one-half point mark-up but rather confirms the customer at five and one-half dollars net. At British American we send an open order notice to a customer offering that customer an option for $3,500.00. If that same option during the five day period is bid for by the customer that customer will receive that option for $3,500.00 even if the market goes up and the cost of the option to British American increases to $3,600.00. During that same period of time British American must assume the risks of market changes and fluctuations, which could and at times have substantially increased British American's cost of the option. British American honors its contract to the option customer regardless of market increases that arise as per the above described example. To me it could not be clearer that British American offers options to its customers as a risk transaction i.e. as a principal trade. Equity dictates that British American commodity options trading be treated on an equal level with principal trading in the securities industry. Option disclosure of mark-up on each and every option places an unrealistic hardship on back offices handling these transaction. Such disclosure will create paperwork snarls similar to the 1968 back office problem in the securities industry. Such disclosure requirements will upset the books and record keeping as presently maintained and place our clients in peril. Furthermore, I was of the impression thatunder the Commodity Act as it stands, the CFTC was not given the authority to control mark-up. By mandating disclosure of mark-up, the CFTC is in fact controlling mark-up and violating its congressional mandate.

15. Section 32.5 (d) (5) requires disclosure of "the date the commodity option was executed." This is unnecessary as at times a dealer will purchase options for his own account which he will resell to his customers as opposed to merely purchasing the option after receipt of the customer's funds. A client seeing this older execution date will be confused even though the price the client pays for the option will be in line with the current market price for the commodity option.

16. The CFTC's comments to the regulation state: "The Commission believes that the foregoing changes in the disclosure requirements of 32.5 will ameliorate many of the concerns expressed by the commentators. While the disclosure requirements have been adopted in a somewhat modified form, the Commission does not anticipate that affected persons should experience particular difficulty in complying with these revised provisions since substantially the same information will be required to be disclosed in this section as

adopted as had originally been proposed. Some of the commentators objected to various aspects of the disclosure statement such as, for example, that the disclosure of mark-ups was unwarranted, exceeded the Commissions' authority and was not in accordance with normal commerical practice. The Commission's authority under 4c(b), as previously indicated, is exceedingly broad and in light of the Commission's knowledge of mark-ups in excess of 100% being charged in some cases, the Commission deems disclosure of such items to be an essential customer protection."

The CFTC's authority is not so broad as the CFTC claims. The CFTC has no authority to mandate mark-up disclosure. Furthermore, most commodity option firms do not charge 100% mark-ups. British American on an average since its inception has charged 33-1/3%. However, this percentage is not as large as it seems. Out of this 33-1/3% mark-up all fees and commissions are paid (e.g. clearing costs, salesman's commission, liquidating costs, etc.). Therefore, if the purchase of the option and the sale of the option or "round turn" had all applicable charges divided equally, the mark-up per transaction would be approximately 16-1/6% for the purchases and 16-1/6% for the sale. Furthermore, British American and other option dealers on gross sales net approximately 8% to 12% per transaction. Thus, any mechanism that deters sales will seriously damage economic viability of British American and/or any other commodity option firm.

17. I believe that an 8% to 10% net profit per transaction is not unreasonable. The very language of the rules as first promulgated in the Federal Register indicated the CFTC's prejudice against the industry, John Rainbolt, Vice Chairman of the CFTC and who had a great deal to do with the writing of these regulations and comments stated in the November COMMODITIES MAGAZINE at page 21: "We have got to clean up the options business in this country first - you have to get the crooks, the bunko artists, the hot check artists, out." He emphasizes "You have to squeeze the business dry." He further says "but I know it's going to be a lot harder for the little guy than it is for the big guys. And I know the little guys in the business are generally the ones ripping off the public." Mr. Rainbolt's remarks clearly indicate his negative opinion of our industry, which opinion is unwarranted based on the facts.

18. I do not see the need for segregation in any form. Historically, there has not been to my knowledge, one default on London commodity options. In our sister securities industry in the case where dealers are selling stock options, there are no segregation requirements to guarantee performance of these options. A good books and records system, as the one used by British American, will insure performance for the client. The establishment of economically impossible segregation will destroy dealers and not insure the investment of the commodity options customer.

19. Exemptions to these segregation regulations are left

strictly to the discretion of the CFTC. This is a dangerous practice. This country was founded on equality of justice. Granting the CFTC such broad exemption discretion will undoubtedly lead to abuses and must be avoided. There should be no segregation and then, no need for discretion.

20. The segregation rules themselves are filled with ambiguity. As I understand segregation, the dollar premium charged by the London Broker and the mark-up on the gross premium is to be segregated at minimum 90¢ on the dollar. No company can operate with this amount of strain on its working capital. The base commission for salesmen selling commodity options is approximately 10% to 12%. Thus, by segregating at least 90% of the gross premium, the option dealer must carry the costs of the option until such time as segregation is no longer mandated, i.e. when the customer liquidates his position.

21. Additionally, the regulation requires adjusted working capital equal to $50,000.00 or the sum of the safety factors described in Regulation 1.117 with respect to proprietory and customer accounts and 5% of the applicant's aggregate indebtedness. What is 5% of the applicants aggregate indebtedmess? What does the CFTC consider as assets? What does the CFTC consider as liabilities? If the capital requirements are construed as written the option dealer would need more working capital than any other regulated industry.

22. A commodity option dealers cash flow using CFTC's capital formula, including segregation, would require a commodity option dealer with 12 million dollars in gross premium income and a customers' equity position of 4 million dollars to maintain a cash position of 90% of 12 million dollars or 10,800,000 plus 5% of the customers' equity of 4 million $200,000 for a grand total of $11,000,000. Also, the commodity option dealer would have to absorb for an operation of this size approximately 23% of gross dollar premiums of $2,760,000. Combined, this would require capital amounting to $13,760.000. This immense amount of capital at today's prime rate 6-1/2% would cost, if you could get the loan, approximately $894,400.00 in interest charges. Using 10% of gross premium income as the average current profit, (without disclosure), this outfit would have $1,200,000.00 pre-tax, precost of money income or a pre-tax income of $306,000.00 with a net income of $153,000.00. In other words, the outfit would have a net profit 1.27% on gross premium income.

23. The above has been presented to the Court to illustrate the impossibility of survival of the commodity options business under the CFTC's regulatory scheme. These regulations do not serve their proported purpose of protecting the public but are designated to destroy the commodity options industry.

24. It should be noted that the National Association of Commodity Option Dealers has recommended to the CFTC and presently is negotiating with the insurance industry to establish a viable

mechanism of bonding whereby the customers will be protected without destroying the vehicle i.e. the commodity options industry.

25. Should the Court wish, I am available at the Court's convenience to further elucidate, explain and comment of the merits of this affidavit.

Respectfully,

Peter E. Aaron

PETER E. AARON

Sworn to me this
2nd day of December, 1976

Martin H. Kaplan

NOTARY PUBLIC

MARTIN H. KAPLAN
Notary Public, State of New York
No. 24-4619073
Qualified in Kings County
Commission Expires March 30, 1977

EXHIBIT TO AFFIDAVIT OF PETER E. AARON

## HELPFUL HINTS

## CONTANGO

Contango is the name used to describe warehousing and insurance costs in metal futures.

## HOW DOES IT WORK

When a future or a call option is held, for each day from the inception date of contract, the option or future holder's value (basis price) includes the prorated contango charge for the time his contract is in force. As the expiration date approaches the contango increases proportionally, therefore, diminishing equity on a daily basis.

The simplest way to describe the contango is:

Each day the contract is in force brings the investor closer to the spot price.
If the spot was £ 900 and a 3 months option was £ 930 then the contango would be £ 30 for 3 months or £ 10 per month.
A 90 day option expiring today would get spot of £ 900.
A contango in force 1 month would be quoted £ 920; for 2 months £ 910.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP. and LLOYD, C[illegible] & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of
the COMMODITY FUTURES TRADING
COMMISSION; JOHN V. RAINBOLT III,
Vice Chairman of the COMMODITY
FUTURES TRADING COMMISSION; READ
P. DUNN, GARY SEEVERS and ROBERT
P. MARTIN, Commissioners of the
COMMODITY FUTURES TRADING
COMMISSION,

Defendants.

MEMORANDUM IN SUPPORT OF
PLAINTIFFS' MOTION FOR A
DECLARATORY JUDGMENT AND
PRELIMINARY INJUNCTION AND
IN OPPOSITION TO DEFENDANTS'
MOTION FOR SUMMARY JUDGMENT

76 Civ 5124 (Knapp)

## PRELIMINARY STATEMENT

The within Memorandum is submitted in opposition to Defendants' Motion for Summary Judgment and supporting Memorandum of Law and supplements Plaintiff's Memoranda of Law dated November 22, 1976 and November 29, 1976.

The overall thrust of the defendants' argument seems to be that the plaintiffs are averse to regulation and wish to operate in an atmosphere of laissez faire. In this they completely misconstrue plaintiffs' position which has always been that reasonable and rational regulations are in the best interest of the reputable members of the industry and the general public. Plaintiffs perforce object, however, to regulations which are:

(a) concededly punitive, arbitrary, capricious and unreasonable, the effect, and, it is submitted, the purpose of which is to force plaintiffs immediately out of an industry they have pioneered because the defendants have indiscriminately and without factual basis labeled all members of the London commodity options industry as "crooks" "bunko artists" and "hot check artists;"

(b) are clearly detrimental to the investing public;

(c) clearly discriminate against London commodity options and retail dealers therein in favor of futures contracts, which are far more risky and leveraged to the investor,[1] and the purveyors thereof;

(d) are inconsistent with each other; and

(e) bear no rational relationship to the operations of the industry to be regulated.

No amount of rhetoric by the defendants can obfuscate plaintiffs' basic position or the unlawful nature of the defendants' actions under 5 U.S.C. §706(2)(A) et seq.

To assist the Court in analyzing these proposed regulations, set forth below is a brief description of the actual method of operations of the plaintiffs herein.

## DESCRIPTION OF THE MECHANICS OF THE OPERATION OF THE PLAINTIFFS HEREIN

1. General Marketing. The plaintiffs utilize the following techniques to obtain new customers:

(a) direct mail;

(b) telephone solicitation, including the use of what are commonly called lists;

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[1] See discussion at page 26, footnote 24.

(c) newspaper advertising;

(d) TV advertising; and

(e) referrals from existing clients.

In the case of plaintiff British American, it is estimated that more than 30% of its existing customers are referrals from existing clients. As to plaintiff Lloyd, Carr & Co., which has been in operation for a far shorter period of time, less than 10% of its customers are now derived from referrals.[2]

2. Customer Orders. Upon receipt of a customer's indication to purchase a commodity option, the company furnishes to that customer what is commonly called an "open order notice". The plaintiff Lloyd, Carr & Co. calls this document a "confirmation and invoice." That document sets forth the following data:

(a) order;

(b) type of option;

(c) commission;

(d) market on which executed;

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[2] Accordingly, the defendants' statement at page 25 that record-keeping is required as to all customers solicited is justified because "[t]his provision imposes no greater burden than placing a check mark next to the name of the customer on the solicitation list utilized" is an oversimplification and another example of their total lack of understanding of the operations of retail commodity option dealers.

(e) contract size of the underlying futures contract;

(f) delivery month;

(g) number of options ordered; and

(h) price per option.[3]

British American's open order notice is to the same effect. It is important to note that the price per option set forth in the open order notice is guaranteed by the plaintiffs for five business days to their customers and, thus, even if they are charged a higher premium by the grantor of the option, they are required to make up the difference out of their own pocket. The open order notice is sent out immediately after the customer furnishes the order. In the normal course of business the customer's order is not executed until his funds are received by the plaintiffs.

Once the customer's funds are received by the dealer, the customer is then sent an execution confirmation slip, or in the case of Lloyd, Carr & Co., what is termed a contract original.[4]

The information reflecting the actual execution of the order on the ICCH and LME is identical to the information furnished on the open order notice with the following additions:

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[3] If the customer's funds are not received by the dealer the customer is under no legal obligation to purchase the option. In terms of the strike price, purchases are usually made at the current strike price for the option at the time the order is executed on the ICCH or LME.

[4] A copy of the open order notice and execution confirmation slip is annexed hereto as Exhibit "A".

(a) the date the option is purchased;

(b) the confirmation date of the option contract;

(c) the strike price per option; and

(d) the reference number.

The reference number exactly matches the reference number on the original option contract purchased by Lloyd, Carr & Co.'s clearing agent, Wilson, Smithett & Cope, Ltd., as well as the books of the ICCH and LME. Prior to computerizing its back office operations, British American also utilized a similar reference system number. But, because of the limitations in the existing software program it has been unable to put such reference numbers on the customers' execution confirmation slip. British American maintains a separate journal for recording these reference numbers for their customers. Both of these companies realized that this type of record-keeping procedure was required to protect their customers' interests in the event of their financial inability to assist the customer in the ultimate close-out of the transaction. This was done at substantial expense and without any guidance from the defendants.[5]

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[5] The defendants were advised of this record-keeping technique by the undersigned in his letter of March 10, 1976 which is annexed to the original moving papers dated November 16, 1976.

### 3. Mechanics of the Purchase of the Option by the Plaintiffs for the Account of Their Customers.

(a) Members of the ICCH or LME furnish quotations for options, both put and call, at varying expiration dates on a current basis on Reuters (two times a day) or via the telephone (as many times as the dealer elects).

(b) Upon receipt of the customer's funds which are time stamped, the plaintiffs transmit their order by telex or telephone to their clearing member who executes the order.

(c) When the order is executed the strike price is fixed as well as the premium to be charged by the grantor of the option. The plaintiffs are advised by telex of the terms of the execution of the customer's order and promptly transmit to their clearing member the necessary funds to pay the premium due to the grantor of the option.

(d) Both the grantor of the option and the plaintiffs' clearing broker record the trade, including all of the necessary data, on their books.

(e) The ICCH also registers the option and, where appropriate, the underlying futures contract on its books setting forth the date and time of execution, the expiration date and the commodity and the name of the broker on either side of the transaction. Furthermore, the clearing member who sold the option (i.e., the writer of the option) must leave the premium intact until the option expires or is closed out.

(f) The details of the transaction are then transmitted to the plaintiffs.

(g) After execution of the option order the writer of the option is required at the close of each business day to mark-to-market the current market value of all open transactions on its books, which would include any options transacted by it through plaintiffs and subsequently executed by their clearing broker. To assure additional financial integrity, under the ICCH By-Laws, the clearing house guarantees fulfillment of each futures option.[6]

Transactions on the LME are similar except that there is no centralized procedure for registering and processing the option. The LME has approximately 33 individual members all of whom are substantial companies who are required to post a bond in excess of $1,000,000.[7]

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[6] For the convenience of the Court, the ICCH "green book" is submitted herewith.

[7] In the past 125 years neither the LME or ICCH have ever defaulted in the execution of an option transacted through them. See Affidavit of James Carr sworn to December 4, 1976, submitted herewith.

4. Close Out of the Option.

(a) When the customer elects to sell or declare his option, he so advises the plaintiffs, who in turn telephone or telex into the clearing member the order.[8]

(b) The clearing member so advises the ICCH and the customer's option is converted to a long futures contract at the same strike price.[9]

(c) Accordingly, on the books of the ICCH, both sides of the original option transaction are now reflected as a long and short futures contract contra to each other.[10]

(d) The clearing member then goes into the market and sells a futures contract short on the ICCH for the benefit of the customer to close out against the long futures contract held for the benefit of that customer.

(e) The net proceeds, which is the customer's equity, is then transmitted to the plaintiffs, who in turn immediately transmit the funds to the customer.[11]

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[8] The beneficial owner of a London commodity option, unlike the beneficial owner of a futures contract, can put in a stop loss order as well as an open market order. For purposes of the description, we will assume an open market order.

[9] See description of haircuts with respect to net capital in Exhibit "C" to the Amended Complaint.

[10] To the extent that this is inconsistent with page 8 of my Affidavit, sworn to on December 3, 1976, the above restatement is more accurate.

At no time during this transaction do the plaintiffs maintain customer's funds for more than 24 hours. Accordingly, segregation is totally inapplicable to dealers who live up to their commitments and purchase the options for their customers. As to those dealers who are "crooks", to paraphrase Vice-Chairman Rainbolt, the segregation requirement would be meaningful since these parties have taken it upon themselves to guarantee the performance of the commodity operation in a direct conflict of interest situation vis-a-vis their customers. This may also violate various criminal statutes and consumer anti-fraud laws.

## THE REGULATIONS WERE ADOPTED WITHOUT OBSERVANCE REQUIRED BY LAW AND ARE VOID UNDER 5 U.S.C. §706(2)(D)

As set forth in plaintiffs' Memorandum of Law dated November 30, 1976, the defendants themselves have taken the position that these are substantive changes to the prior release on October 8, 1976. While defense counsel's representations in open court on December 3, 1976 were that the changes from the regulations published on October 8, 1976 were not material and that all of the changes were favorable to the regulated parties, this is not so. For example, although the minimum financial requirements rule is identical in both releases, because of the different time schedules set forth in the November 24 Federal Register notice, there is now an additional net capital requirement relating to 5% of the customer's equity. As shown in Exhibit "C" annexed to the Amended Complaint, this is a material and adverse change to the parties to be regulated by these proposed regulations.

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[11] To the extent that this equity exceeds the customer's cost of the option, he has a profit. To the extent that the equity is less than the customer's original cost, he has a loss. Where the strike price on declaration is less than the strike price set forth in the customer's purchase, the option is abandoned as the customer realizes no equity.

The statement on pages 48 and 49 of the Federal Register notice of November 24, 1976 clearly does not comply with 5 U.S.C. §553(d), as it does not satisfy the good cause exception to the 30 day notice requirement. Reference is made to the cases cited on page 3 of the Memorandum of Law dated November 30, 1976. If this industry has been fraught with abuses the defendants have available an extremely broad anti-fraud rule which they should enforce.

The plaintiffs contend that the parties to be regulated have been denied meaningful participation in the rulemaking process under the principles enunciated in Texaco, Inc. v. Federal Power Commission, 412 F.2d 740 (3d Cir. 1969). As shown in the Exhibits to the plaintiffs' application with the Complaint, the proposed rules first published on October 8, 1976 were a dramatic and substantial departure from anything being considered by the defendants prior to that date. (See Appendix to original moving papers setting forth the prior proposals and published Advisory Committee Report.)

The defendant's position that they have spent over 19 months considering these regulations, as shown by their February 1976 regulations and the Advisory Committee Report as the basis for violating the clear provisions of 5 U.S.C. §§553(d) and denying pre-enforcement judicial review, is also factually improper. The February 20, 1976 notice proposed rules specifically stated:

> (a) the Commission has proposed not to impose segregation requirements on premium as to commodity options dealers;
>
> (b) disclosure by dealers would be required by way of substantial filings with the CFTC, along the lines of reports by securities broker-dealers with the S.E.C. and not by way of a punitive and discriminatory disclosure statement to potential or actual customers;
>
> (c) minimum financial requirements, with one notable exception, which were rationally related to the actual operations of the members of the industry;
>
> (d) registration not required as an FCM since that is prohibited by Reg. 1.19; and
>
> (e) completely different record-keeping requirements.

At page 15 of their brief, defendants' counsel admits as to some of these. In short, the substantive portions of these regulations, as to which plaintiffs object, first came on the scene on October 8, 1976. Everything prior thereto is for all intents and purposes meaningless.

No member of the Advisory Committee or the persons who drafted or considered these regulations in October and then November 1976 has ever been affiliated in any manner with a retail London commodity options dealer nor was anyone affiliated with the parties to be regulated consulted on the preparation of these regulations.[12] A review of the regulations in light of the operational aspects of this business is the best evidence that none of such persons had any knowledge of this business and apparently was unwilling to take the time and effort to learn of the mechanics of this industry, ergo, imposing identical but far more severe regulations on options dealers, which have abolutely no relationship to this business.

In addition, the defendants are misinterpreting United States v. Florida East Coast Railway Co., 410 U.S. 244, 93 S.Ct. 810, 35 L.Ed.2d 223 (1973) and United States v. Allegheny Ludlum Steel Corp., 406 U.S. 742, 92 S.Ct. 1941, 32 L.Ed.2d 453 (1972). A careful reading of those cases clearly supports the plaintiffs' position. In United States v. Florida East Coast Railway Co. (supra), there were extensive hearings conducted and witnesses examined. The agency asked for and received detailed information from the parties to be directly regulated and their comments were then submitted to all of the other parties before the final regulations were published in the Federal Register. Accordingly, the plaintiffs in that case were not in a position to argue that the federal agency had insufficient data upon which to based its regulatory scheme. Under the circumstances in that case there was no need to hold another round of hearings and further investigations because the agency clearly understood the area to be regulated and had the factual data, after hearings, upon which to base a regulatory scheme which had a rational relationship to the parties to be regulated. Such is clearly not the case in the instant situation where not only have the defendants excluded the parties to be regulated from meaningful participation but the regulating scheme promulgated evidences a complete lack of understanding of the operations of the parties to be regulated.

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[12] Some of the persons on the Advisory Committee represent or are affiliated with the very companies who could directly benefit by the elimination of substantially all of the present commodity options dealers with whom they are now competing.

Thus, in accordance with the foregoing cases, plaintiffs' counsel and certain other parties requested an administrative hearing to take evidence necessary for the promulgation of reasonable and rational regulations for the protection of the general public as well as the plaintiffs herein. Those hearings would have conclusively shown that there is no basis in fact for many of the conclusory justifications proferred by the defendants to support certain of these rules and that these punitive regulations have no relationship to the operations of this industry.[13]

Not only did the defendants refuse to respond to this request, it was only through the courtesy of one employee of the Office of General Counsel that the plaintiffs or anyone else in the industry became aware that the defendants did not intend to hold any hearings or any other procedure and were adopting the regulations in accordance with the schedule published in the Federal Register on October 8, 1976. The defendants attempts to sneak through the October 8, 1976 regulations, by lulling the regulated parties, were buttressed by their release to the general public of the Commission agenda annexed to the minutes of its meeting on September 13, 1976 showing oral public hearings on December 1, 1976, a copy of which is annexed hereto as Exhibit "B", and news releases saying that they were considering substantial revisions.

Unfortunately, as a result of the defendants' violations of both the spirit and the letter of 5 U.S.C. §§553(d) in their avowed attempt to eliminate an entire existing industry for the benefit for a favored few large securities broker-dealers, they have devised rules and regulations

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13. United States v. Allegheny Ludlum Steel Corp. (supra), is to the same effect. In that connection, it should be noted that there were 50 days of hearings by a hearing examiner to obtain the necessary data prior to the adoption of the rules and the Supreme Court held that such rules were "reasonable" and substantial evidence supported the Commission's conclusion. Press releases are no substitute for evidence.

which are inconsistent within themselves and are totally unworkable. Accordingly, the regulations should be declared null and void.

## APPLICABLE LAW AS TO DECLARATORY JUDGMENT

The points and authorities discussed in plaintiffs' original Memorandum of Law dated November 22, 1976 are not refuted or answered by the defendants in their Memorandum of Law dated December 3, 1976. It is self-evident that these regulations are subject to being held unlawful under the various provisions of 5 U.S.C. §706(2)(A) et seq. The defendants' position is that since they allege that they have the right to abolish commodity options it follows that the Court has no jurisdiction to void such regulations pursuant to 5 U.S.C. §706(2)(A) et seq.[14] It is axiomatic that the power to regulate is not the power to destroy and limitation is not the equivalent of confiscation. Stone v. Farmers Loan & Trust Company, 116 U.S. 307, 29 L.Ed.2d 636, 6 S.Ct. 334 (1885). Their interpretation of 4c(b) of the Act is a conclusion which is not supported by the statute or the underlying legislative history which specifically requires them to adopt regulations relating to commodity options. 7 U.S.C. §6(c)(b) (Supp. V 1975) S.Rep. 93-1194 93d Cong., 2d Sess., 40 1974.[15]

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14. See discussion and cited case on page 5-8 of plaintiffs' Memorandum of Law dated November 22, 1976.

It is obvious that Congress intended thoughtful and proper regulations. In this connection it should be noted that the plaintiffs and certain other members of this industry at their own expense and risk and without any guidance from the defendants developed a methodology which not only protects the investing public but has fostered an important new investment vehicle. Under these circumstances and in view of the present posture of this litigation, the rules should be declared null and void and the matter referred back to the agency for appropriate hearings and revision. Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 91 S.Ct. 814 28 L.Ed.2d 136 (1971).[16]

## SECTION 32.6 - SEGREGATION

The segregation requirements bear absolutely no relationship to the operations of this industry or the protection of customers. In the first place, it does not guarantee performance on the customer's unrealized profits above the premium paid for the transaction. In the second place, as the expiration date of the options nears, the value of the premium declines; it is axiomatic that the longer the

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15. The plaintiffs have never contended that the Commission is estopped from regulating plaintiffs.

16. If Congress arbitrarily sought to eliminate the commodity options business it would violate due process under the Fifth Amendment which a fortiori applies to the defendants as well as the provisions of 5 U.S.C. §706(2)(A), (B) and (C).

term of the option the higher the cost to the customer. See letter of Shearson, Hayden Stone & Co. by Max Liebler, dated November 1, 1974, in part four of the defendants' Appendix.

A detailed analysis of the disastrous effect of the arbitrary and punitive segregation requirements is set forth at pages 4 through 8 of the undersigned's letter to the defendants dated November 4, 1976, which is annexed as Exhibit "D" to the Amended Complaint and is hereby incorporated by reference. For all practical purposes the reduction of double segregation from 100% to 90% is meaningless as in terms of negative cash flow; each $1.00 of cash income will result in $3.50 cash outlay. The defendants' Memorandum and Appendix do not retort or answer any of the points raised therein.

It has always been the undersigned's position that from the customer's point of view, the crucial factor in the protection of the customer's equity is the preservation of his right to close out the option when he so elects. A problem could only arise if there is both an intervening bankruptcy of a retail commodity option dealer, and no method to promptly trace the customers' option to the ICCH or LME to effectuate a close-out. The segregation requirements are clearly punitive, arbitrary, capricious, and unreasonable and are totally unrelated to protecting the customer or his equity in an option.

The solution is so obvious and has been voluntarily adopted by the plaintiffs herein: appropriate record-keeping and information furnished to the customer so that in the event the dealer becomes insolvent, the trustee in bankruptcy or other appropriate party, as the case may be, knowing the reference number of a particular option held by the customer, which is also reflected on other records at the retail dealer, clearing member firm and the ICCH, is in a position to immediately effectuate the close-out of the option when the customer so elects.[17]

As to the plaintiff British American, prior to becoming computerized, they also utilized this method and, as shown in the public testimony of Charles J. Hecht, on March 8, 1976, the defendants were advised of this procedure, which was initiated by British American when it began operations in October 1975. British American has now computerized the operations of its back office and the parameters of the software program utilized by British American and other dealers of commodity options do not now permit the inclusion of the reference number. However, the back office department of British American has advised the undersigned that under these circumstances, provisions can be made for the manual insertion of the reference number on the customer's confirmation slip. A separate ledger of reference numbers for all customer options is maintained at all times.

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17. If the clearing broker's name is furnished to the customer upon request, he can close out his position through a dealer of his choice.

In this connection, it should be noted that the underlying basis of the defendants' justification of segregation can only be that the guarantees of the ICCH members and their requirement to segregate all option premiums plus mark-to-market the equity in all transactions at the close of business every day, and the ICCH itself, as well as the member guarantees of the LME plus a substantial bond are worthless. However, as the defendants well know, there has never been a default on either the ICCH or the LME with respect to options transacted through those exchanges in over 100 years of operation.[18] No wonder the defendants never wanted to hold any evidentiary hearings with respect to segregation, because the uncontradicted evidence would have shown that there was no factual basis to justify the admittedly punitive segregation provisions promulgated in these rules and regulations. No wonder the defendants never held the public hearings.

In addition, members of the LME are required to post substantial bonds to further guarantee performance while the ICCH itself guarantees the execution of the option even if one of its members should happen to go into bankruptcy or be unable to perform. In addition, the ICCH is extremely well automated and efficient in processing options and along with the LME, is the only facility which mark-to-market each option at the close of business on each day. See letter from George Lamborn of Shearson Hayden Stone & Co. to William T. Bagley dated April 5, 1976, included in Part 3 of defendants' Appendix.[19] Furthermore, in the event that a member ever defaulted in the future, it would for all practical purposes destroy commodity option trading in London. This would be pennywise and pound-foolish and the defendants' hypothetical assumption that this may happen, as the purported but unstated rationale justifying segregation, is clearly not justified by past experience or common sense.

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[18] Query, as to the recent potato scandal and the statement in the explanatory preface to the regulations, that the defendants' "experience in the field of futures contracts has been salutory in comparison to the options area"? (at page 7).

The simple solution, which has been raised by the industry independent of the defendants, is to have a net capital rule which insures the financial stability of the option dealer and suitable record-keeping requirements subject to the staff's inspection powers. The real issue is why are the defendants unwilling to properly discharge the regulatory functions which were given to them in the Commodity Exchange Act of 1974, as amended?

The defendants' segregation approach is so poorly conceived that it borders on the ridiculous. There are three possible alternatives. The first is to sell naked options. In this way the dealer does not have to pay for the premium to the writer of the option as he never actually purchases the option for the customer and, thus, he eliminates the financial hardship of segregation. Of course, everyone knows that the writing of naked options was the abuse which resulted in the 1974 amendments to the Commodity Exchange Act and the creation of the CFTC as an independent regulatory agency. To now permit and encourage the writing of naked options is clearly contrary to the public interest. It is also clearly a fraud and violates state criminal laws such as embezzlement and grand larceny. Furthermore, it encourages churning which as to the investors in commodity options is clearly against their best interests. The second alternative is to immediately go out of business.

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[19] See ICCH "green book".

The third alternative is to have the dealer obtain suitable financing to comply,[20] which as shown in the undersigned's comment letter dated November 4, 1976, forces the plaintiffs and other dealers similarly situated into a noncompetitive position and is economically impracticable since the finance charges exceed their gross profits. The finance charges, estimated at 2% above prime (which is presently 8-1/2% to 9% per annum), are far in excess of the interest earned on government obligations.[21]

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[20] See pages 39 and 40 of defendants' brief.

[21] The defendants assume that financing will be available. However, even if you could obtain financing, who would want to? The business is now not only economically unfeasible but it does not make sense in an industry which cannot meet competition and is faced with a regulatory bias.

The only entities that will profit are the large securities broker-dealers who are very willing to finance the segregation. Everyone else loses. The investing public will have these increased costs passed on to them, thus diminishing their chances to profit and the amount of any profits. What happened to the concept of protecting the investor? The plaintiffs and other retail dealers will be required to increase their mark-ups to cover such additional expenses in order to remain solvent. They will thus become non-competitive with the major wholesalers of options and purveyors of futures contracts and CBOE options in direct violation of 7 U.S.C. §19. Why should commodity option dealers be treated as a pariah?

In direct conflict with this "justification" is the defendants' position under the disclosure provisions that retail dealers must disclose their mark-ups because it is their belief that certain dealers have too high of a mark-up. Who are the defendants trying to fool? The short and simple result will be to force the plaintiffs to immediately cease operations.

In addition, at least as early as March 1976, the Commission was asked to consider the utilization of the Securities Investors Protection Committee and insurance and bonding and the suggestions were dismissed out of hand. See testimony of Charles J. Hecht in Appendix 3 to the defendants' brief at pages 142, 177, 178, 179 and 180. As heretofore shown, the defendants have used every tactic to rush these regulations into effect. To now take the position that the regulated parties have not come up with a viable alternative in the last six weeks is unconscionable.

## MINIMUM FINANCIAL REQUIREMENTS

British American believes it is the largest company in the country which is exclusively engaged in the sale at retail of London commodity options. Although it has built up a substantial net worth through retention of earnings, it cannot even come close to satisfying the minimum financial requirements specified in the new rules.[22] If British American, which is the largest of such companies, is completely unable to comply with this requirement, it follows that every other retail dealer of commodity options in the United States will have to close their doors.

The undersigned agrees that the $50,000 set forth as the "minimum net capital" is an alternative figure and not cumulative with the factors set forth. However, under Regs. 1.17(c)(2)(xi), (e)(2)(xii) and (c)(4)(ii), the plaintiffs, for purposes of computing "minimum net capital" are required to exclude all income for the next six to 18 months while they will be charged with all expenses. The operating expenses of British American, exclusive of premiums and sales commissions, average over $200,000 per month and thus, sometime within the next few months it will violate the "minimum net capital" provision.

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[22] Item B(1) in Exhibit "C" to Amended Complaint should read "1/2 of 1% of customer's equity in the underlying futures contract."

As to the alternative test the undersigned disagrees with the position of the defendants that aggregate indebtedness does not include customers' equity. See Exhibit "C" to the Amended Complaint. The specific wording of Reg. 1.17(7) speaks for itself and defendants cite no contrary authority.

As to the 1/2 of 1% "haircut", commodity options give the customer the right to buy a commodity futures option at a specified strike price during the option period. Once having paid the premium, the customer can at any time convert into the underlying futures contract on a margin basis or use the option as collateral for trading in futures contracts as a hedge. Thus, the plaintiffs' interpretation is in accord with the economic realities of the transaction and consistent with the defendants' approach of requiring this industry to be treated in almost all respects as purveyors of futures contracts.

Contrary to the oral statements of defense counsel to the Court prior to the hearing on December 3, 1976 that Reg. 1.17 applies only to persons who are registered as FCMs (and since plaintiffs are not yet registered it is not yet applicable to them), it is the official position of the defendants, as stated in footnote 60 on page 36 of their brief that such financial requirements are also applicable to persons who apply for registration. Accordingly, neither of the plaintiffs can apply for FCM registration since they do not meet the financial requirements. On the other hand, the defendants have stated in their explanatory preface that applications should be filed 30 to 60 days before January 17, 1977, the date after which unregistered engagement in option transactions is outlawed by §32.3. The undersigned presumes that the defendants' response will be "raise additional capital." In view of the confiscatory regulatory scheme, this is the ultimate pipe dream as no one in his right mind would invest in a business which by regulation is rendered unfeasible to operate.[23]

As the persons who drafted this rule, the defendants should be in the best position to tell the court exactly how adjusted working capital is computed, yet they criticize the calculations in Exhibit "C" to the Amended Complaint without specifying any authority for their criticism. Furthermore, as pointed out in Exhibit "C", they are placing the plaintiffs and other dealers in a conflict of interest position as to its customers. The more equity the customers have in their options the more severe the financial requirements of the dealer. In short, the very success of a dealer's customers would force it to close its doors. The customers of this industry are an extremely valuable asset which these regulations will deliver at little or no cost to those favored few large diversified brokerage houses, who will be in a position to dominate the industry and pick up the pieces.

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[23] See discussion as to segregation.

Since as stated above on page 9 the plaintiffs at no time hold customer funds for more than 24 hours, there is no rational basis under the guise of "public protection" for the imposition of onerous and punitive capital requirements.

## DISCLOSURE

Plaintiffs have no quarrel with the concept of full and fair disclosure. They do, however, object to arbitrary disclosure requirements directed solely at this industry which places it at an obvious competitive disadvantage in relation to purveyors of commodities futures contracts[24] and CBOE stock options. No amount of money could replace the customers who will be lost.

The second concern of the plaintiffs is that many of the mandated disclosure statements will subject the plaintiffs to immediate civil and criminal penalties for violation of the general anti-fraud provision promulgated under the Commodity Exchange Act of 1974, as amended. Reference is made to the Affidavit of Charles J. Hecht sworn to on December 3, 1976. As was pointed out in the discussion in open court on December 3, 1976, there is no way accurately to describe the potential effect of future currency revaluations. However, §32.5(a)(4) requires "a clear explanation of the effect of any foreign currency fluctuations with respect to commodity option transactions which are to be executed on or through the facilities of a foreign board of trade." Consideration should also be given to the substantial financial burden such requirements will impose on the back offices of the plaintiffs. Finally, it should be noted that the Commission's justification for disclosing mark-ups not only does not reflect the substantial risk to the dealer of a rise in the grantor's premium but is inconsistent with the segregation requirements. The defendants blithely assume that the additional costs will be passed on to the customer, while at the same time justifying the disclosure of mark-ups by contending that they are too high. This is another example of the defendants' deliberate scheme to destroy the plaintiffs' business. They have assumed that the court will let certain provisions slip through to accomplish the desired result, the concentration of this entire industry in the hands of a few large dealers, in direct contravention of 7 U.S.C. §19.

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[24] A commodity option is a safer investment than a futures contract in two important aspects: (a) the customers cannot lose more than their initial investment, i.e., there are no margin calls as in the case of the usual futures contract purchase, and (b) intervening adverse price fluctuations between the date of purchase and the declaration date cannot wipe out investments as in the case of a futures contract if margin calls are not met.

## REGISTRATION PROVISIONS

Final and incontrovertible evidence of the statutory scheme to eliminate all London commodity option specialty houses such as the plaintiffs' lie in the companion provisions of §32.3 and §1.19. Under the former section, the plaintiffs and others similarly situated, by registering as futures commission merchants to avoid the Scylla of being put out of business for violation of that section, run head on into the Charybdis of the latter section which prohibits option dealing by futures commission merchants.[25]

It should be noted that the exemption provisions of §32.4(b) apply by their terms only to Part 32 and accordingly have no application to §1.19 which is contained in Part 1.

## INJUNCTIVE RELIEF

The plaintiffs are seeking declaratory relief as set forth above under 5 U.S.C. §706(2)(A) et seq. based upon the arbitrary and unlawful actions of the defendants in the promulgation of a discriminatory and confiscatory regulatory scheme.

In the alternative, the plaintiffs seek injunctive relief against the enforcement of these regulations. The standards for such relief are well established and, it is submitted, have been fully met by the plaintiffs in these proceedings. Such standards are clearly set forth in Stark

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[25] Reg. §1.19 reads: "No futures commission merchant shall make, underwrite, issue or otherwise assume any financial responsibility for the fulfillment of, any transaction which is of the character of, or is commonly known to the trade as an 'option'."

v. New York Stock Exchange, 466 F.2d 743 (2d Cir. 1972) where the Court stated:

> "Appellants assumed the burden of demonstrating either a combination of probable success and the possibility of irreparable injury or that they have raised serious questions going to the merits and that the balance of hardships tipped sharply in their favor." at page 744

See also Exxon Corporation, et al. v. City of New York, et al., 480 F.2d 460 (2d Cir. 1973); Gulf & Western Industries, Inc. v. The Great Atlantic & Pacific Tea Company, et al., 476 F.2d 692 (2d Cir. 1973); Checker Motors Corporation v. Chrysler Corporation, 405 F.2d 319 (2d Cir. 1969).

It is submitted that the plaintiffs have clearly raised "serious questions going to the merits" and that as the Court found at the hearing December 3, 1976, no injury to the public will occur if these regulations are held up during the Court's consideration of the merits so that "the balance of hardships" tips sharply in plaintiffs' favor in maintaining the status quo. (Transcript at page 34.)

In addition it is submitted that the plaintiffs have more than met their burden of proof that the promulgation of these regulations will cause them irreparable injury, even the disclosure provisions which, it is conceded, will at worst bring about a lingering death rather than the speedy dispatch of the segregation provisions.

"Irreparable injury is suffered where monetary damages are difficult to ascertain or are inadequate." Danielson v.

Local 275 Laborers Union, 479 F.2d 1033, 1037 (2d Cir. 1973). In that case, the Court found that since damages could not be readily or accurately determinable, that there would be irreparable harm and it was wrong "to withhold equitable relief simply because the picketing has failed to shut down the operation but only delays performance which results in incurring of expenses and prevention of profits."

The loss of customers resulting from the impaired competitive position of the plaintiffs and other option dealers under the disclosure requirements, to say nothing of the almost certain loss of their businesses under the segregation, minimum capital, and registration provisions presents a clear case of irreparable injury warranting injunctive relief.

## CONCLUSION

WHEREFORE, the undersigned, on behalf of the plaintiffs, respectfully requests that the Court issue a declaratory judgment declaring the regulations relating to commodity options as published in the Federal Register on November 24, 1976, to be null and void, or, in the alternative, that the Court preliminarily enjoin the defendants from implementing or enforcing the said regulations, and for such other and further relief as the Court deems just and proper under the circumstances.

Dated: New York, New York
December 9, 1976

Charles J. Hecht
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Haig Costikyan
Of Counsel

EXHIBIT "A" TO MEMORANDUM OF LAW

COMMODITY
BROKER/DEALERS
and
OPTION
SPECIALISTS

**LLOYD, CARR & CO.**

EXECUTIVE OFFICES
84 STATE STREET
BOSTON, MASS. 02109
TELEPHONE (617) 723-3100
TELEX 94-0953

TRANSACTION NO.

We have this day, upon your specific authorization, accepted your order to purchase from/thru us as broker/dealers the following option(s) on the indicated futures contract(s).

| ORDER DATE | OPTION (b) | COM | MARKET (c) | CONT SIZE | UNIT | DELIV MONTH | BRAN | BRO |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

| NO. OF OPTIONS | PRICE PER OPTION | INVOICE AMOUNT |
|---|---|---|
| | | |

1

NOTES

a.) This is not your final contract. It will be followed by a Contract Original and Execution Authorization.

b.) Put Option is the right to sell at strike price at a later date; Call Option is the right to buy at strike price at a later date.

c.) LME - London Metals Exchange.
ICCH - International Commodity Clearing House.

CONFIRMATION AND INVOICE (a)

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COMMODITY
BROKER/DEALERS
and
OPTION
SPECIALISTS

**LLOYD, CARR & CO.**

EXECUTIVE OFFICES
84 STATE STREET
BOSTON, MASS. 02109
TELEPHONE (617) 723-3100
TELEX 94-0953

TRANSACTION NO.

We hereby transfer to you, from/thru ourselves as broker/dealers, in accordance with your instructions and payment therefor, the following option(s) on the indicated futures contract(s).

| ORDER DATE | OPTION | COM | MARKET | CONT SIZE | UNIT | DELIV MONTH | BRAN | BRO |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

PURCHASE DATE
TERMINATION DATE (b)

| NO. OF OPTIONS | PRICE PER OPTION | AMOUNT PAID |
|---|---|---|
| | | |

STRIKE PRICE PER UNIT
REFERENCE NO.

2

NOTES

(a) This is your only Contract. Keep it and the accompanying Execution Authorization.

(b) IMPORTANT – To realize any equity that may have accrued in this option, you MUST complete, sign and return the accompanying Execution Authorization so that we receive it BEFORE the termination date. We accept no responsibility for equity in any option that lapses if such Authorization is not so received.

EXHIBIT "A"

## EXHIBIT "B" TO MEMORANDUM OF LAW

## OPTIMISTIC TIMETABLE TO IMPLEMENT OPTIONS POLICY DIRECTIVE

X = Date of Commission Policy Directive 9/13/76

I) X + 7 days -- OGC submits to Operations Council proposed 9/20 Federal Register Notice and regulations incorporating Commission appproved policy directives suggested in Part A.

II) X + 14 days -- Item I above submitted to Commission, as revised in accordance with Council comments. 9/27

III) X + 20 days -- Publication of Item I above, as revised in accordance with Commission comments. The release would indicate that regulations become effective 30 days after publication with registration requirements becoming operative 60 days thereafter, but also would request comments on the proposals. Oct 3

IV) X + 30 days -- OGC submits to Operations Council proposed Federal Register Notice and regulations, incorporating balance of Commission approved policy directives. Oct 13

V) X + 44 days -- Item IV above submitted to Commission, as revised in accordance with Council comments. Oct 27

VI) X + 50 days -- Publication of Item IV above as revised in accordance with Commission comments. Publication for comments on the proposals for 30 days. Nov 1

VII) X + 80 days. Oral hearing on regulations. Dec 1

VIII) X + 90 days. Revision of final regulations and Federal Register Notice to Operations Council. Dec 11

XI) X + 100 days. Final Regulations and Federal Register Notice to Commission. Dec 21

X) X + 110 days. Publication of Final Regulations. Dec 31, 1976

"B"

## AFFIDAVIT OF JOHN FORMA

STATE OF NEW YORK )
) SS.:
COUNTY OF NEW YORK )

## AFFIDAVIT

John Forma, being duly sworn, deposes and says:

1. I am the President of the plaintiff British American Commodity Options Corp. ("British American"), one of the plaintiffs herein, and submit this Affidavit in support of Plaintiffs' Application for Declaratory Relief under 5 U.S.C. §706(2)(A) et seq. and, in the alternative, a preliminary injunction with respect to regulations published in the Federal Register by the defendants on November 24, 1976.

2. Deponent believes that British American is the largest company exclusively engaged in the retail sale of London commodity options in the United States. British American began operations in October 1975, and by no stretch of the imagination can a company such as British American be compared to the major companies in the United States.

3. I have reviewed the description of the mechanics of the operation of British American set forth on pages 2 through 9 of our Memorandum of Law and represent to the Court that this is an accurate summary of the relevant operational techniques of British American.

4. A review of the papers submitted by the defendants indicates that they have placed great reliance on the Advisory Committee's Report published in July 1976. However,

after a review of the list of members of that Advisory Committee and the persons employed by the CFTC who drafted the rules published in October and November, deponent realized that none of these persons were in any way affiliated with or employed by a retail London commodity option dealer, which is the subject matter of these proposed regulations.

5. Based upon information and belief, no member of any company engaged in the retail sales of London commodity options was even consulted by the Advisory Committee and the staff of the CFTC did not consult any members of the industry to be regulated. The fact that they subsequently granted minimum lip service to the many serious comments raised by various parties, not all of whom are "crooks", "bunko artists" or "hot-check artists", is no remedy for a regulatory scheme that is totally unrelated to the operations of this industry.

6. The back office of British American is presently computerized and, thus, the confirmation slips now generated by our computer do not reflect a reference number. At substantial expense and inconvenience, irrespective of whether or not the Court rules in our favor, I have directed our back office to manually insert the reference number on the confirmation slips. In this connection it should be pointed out that sometimes we receive the reference number by mail instead of telex and this will result in a 24-hour delay in furnishing the execution confirmation slips to our clients. In addition, British American has always maintained a sep-

arate ledger setting forth the customer's options in relation to the option number carried on the books of its clearing broker.

7. With respect to the minimum financial requirements, I have instructed my accountants to once again review the proposed regulations as it is my belief that by superimposing the computations utilized by sellers of futures contracts on margin, there are so many questions raised as to the proper interpretation that British American does not know whether it complies with these new rules and thus is not in the position to file its application at this time.

8. As to the 1/2 of 1% haircut, British American has independently verified this through a major brokerage house which deals in both commodity options and futures contracts and they are fully in accord with the interpretation set forth in Exhibit "C" to the Amended Complaint.

9. In every way these regulations are totally unsuitable to this industry as even the defendants concede British American has attempted to actively assist the defendants in formulating meaningful regulations. It is the general public's best interests and our best interests that suitable, reasonable, and appropriate regulations be formulated. Rather than letting the business disintegrate, I will, while I still have some bargaining powers, sell the entire business of British American to a major securities firm for a nominal

consideration on the condition that the purchaser of British American will properly take care of our customers who have supported us throughout these difficult times and have enabled my business to become a meaningful member of the investment community.

WHEREFORE, deponent respectfully requests that the Court grant the relief requested and deponent undertakes that he will, if so requested, assist the defendants in formulating suitable and proper regulations.

John Forma

Sworn to before me this
______ day of December, 1976.

Notary Public

# AFFIDAVIT OF JAMES CARR

## AFFIDAVIT

I, JAMES CARR, doing business as Lloyd, Carr & Company, of 84 State Street, Boston, Suffolk County, Massachusetts, hereby make affidavit that:

1. Lloyd, Carr and Company is a commodity option dealer in the business of selling commodity options to its clients.

2. Metal options are bought directly for the Lloyd, Carr account on the London Metals Exchange (hereinafter called the LME) by a ring dealing (hereafter called clearing) member of that exchange.

Sugar, cocoa and coffee options are purchased for the account of Lloyd, Carr on the appropriate terminal market trading in that commodity; the contract for these "soft" options is issued by the International Clearing House (hereinafter called the ICCH).

All options are issued in the name of Lloyd, Carr and Company, are signed by an officer of the clearing member firm, and are held by Lloyd, Carr and Company in a fire proof UL-approved safe in Boston. (See Exhibit A for a copy of a soft option.)

3. Capital and reserves of the ICCH are represented in its official brochure as being considerably in excess of £10,000,000. Capital and reserves of the LME clearing member are certified to be in excess of even that sum. To quote the LME brochure:

> "Membership of the Exchange is by election and all prospective members must provide evidence of their integrity and financial standing. In addition, firms or companies with ring dealing privileges must furnish substantial bank guarantees and other security. It must be recognized that the London Metal Exchange is a "Principals' Market" and that there is no "force majeur" clause (failure to deliver due to circumstances beyond control) on any contract."

It has been represented to me by officials of both exchanges as well as by officers of both clearing members firms that trade for our account that there has never, in all 128 years of operation of these Exchanges, been a failure to perform on an option contract.

4. Lloyd, Carr, upon purchase of the option, forwards a contract of its own to the client, that contract being copy 2 of an eight part form.

This contract original is signed by an officer of Lloyd, Carr and includes seventeen (17) different pieces of information fully describing and identifying the specific options.

Included in this information is a Reference No. (See Exhibit B). This Reference No. exactly matches the Reference No. on the original purchased by Lloyd, Carr and signed by an officer of the ICCH or LME clearing member. The exact option thus is registered in the books of the ICCH or the LME member and, should Lloyd, Carr for any reason cease operations, this option can instantaneously be identified and exercised by any duly authorized party.

It is apparent to the writer that double segregation as suggested by the CFTC, because it would require the option dealer in the U. S. to use his own or borrowed funds to purchase an option while segregating customers' funds would:

1. Encourage the unscrupulous dealer to refrain from buying the option, preferring to "book" the order, "winning" when the customer "loses" and "losing" when the customer "wins". Notably, this handling of the client's order is not expressly forbidden in these new regulations.

2. And, what kind of advice could the dealer be expected to give his client under these circumstances -- "good" or "bad"?

3. Although isolating his initial investment, nothing is done to assure the client receiving any profits which his or his broker's wisdom and his investment may earn him.

The method of transacting option sales utilized by Lloyd, Carr, however, assures that the client's profits will come back to him and his best interests will be served.

Dated this Sixth day of December, 1976, at Boston, Massachusetts.

James A. Carr

JAMES CARR, d/b/a Lloyd, Carr & Co.

COMMONWEALTH OF MASSACHUSETTS

SUFFOLK, SS. Dec 6, 1976

The personally appeared the above-named James Carr d/b/a Lloyd, Carr & Co., and acknowledged that the statements set forth above in the foregoing affidavit are upon his own knowledge, information or belief and that those statements made upon information and belief he believes to be true, before me

Patricia A. Mills

Notary Public

My Commission Expires: 8/25/83

# London Raw Sugar Terminal Contract No. 2

FORM 1

(ISSUED BY INTERNATIONAL COMMODITIES CLEARING HOUSE LTD.)

To Messrs Lloyd Carr & Co., Client

I/We have today 3rd September, 19 76 Bought/Sold, for your account, the undermentioned number of lots of 50 tons each of Raw Cane Sugar of the Sugar Standard defined in the Rules and Regulations of THE UNITED TERMINAL SUGAR MARKET ASSOCIATION and on the terms noted below.

for and on behalf of
WILSON, SMITHETT & COPE LIMITED

(Signed) Broker

DIRECTOR

| ERENCE No. | DELIVERY MONTH | CONTRACT PRICE per ton £ | dec's | No. of Lots of 50 tons each SOLD | BOUGHT | COMMISSION per Lot | REMARKS |
|---|---|---|---|---|---|---|---|
| **CALL OPTION** | | | | | | | |
| 3252 | Mch. 1977 | 152 | 50 | | 2 | £18.00 | Premium £18.00<br>Declaration date 1.2.77.<br>WHOLE OR PART |
| | | TOTAL | | | 2 | | |

**APPLICABLE LAW**

The Uniform Law on the International Sale of goods shall not apply to this Contract.

COMMODITY
BROKER/DEALERS
and
OPTION
SPECIALISTS

**LLOYD, CARR & CO.**

EXECUTIVE OFFICES
84 STATE STREET
BOSTON, MASS. 02109
TELEPHONE (617) 723-3100
TELEX 94-0953

**TRANSACTION NO.** 7603

We hereby transfer to you, from/thru ourselves as broker/dealers, in accordance with your instructions and payment therefor, the following option(s) on the indicated futures contract(s).

James A. Carr

| ORDER DATE | OPTION | COM | MARKET | CONT SIZE | UNIT | DELIV MONTH | BRAN | BRO |
|---|---|---|---|---|---|---|---|---|
| 9/1/76 | CALL | SUG | ICCH | 50 | T | MAR | BOS | AJM |

PURCHASE DATE 9/3/76

TERMINATION DATE (b) 2/1/77

| NO. OF OPTIONS | PRICE PER OPTION | AMOUNT PAID |
|---|---|---|
| 2 | $2220 | $4440 |

STRIKE PRICE £152.50 PER UNIT

REFERENCE NO. 3252

2

NOTES

(a) This is your only Contract. Keep it and the accompanying Execution Authorization.

(b) IMPORTANT – To realize any equity that may have accrued in this option, you MUST complete, sign and return the accompanying Execution Authorization so that we receive it BEFORE the termination date. We accept no responsibility for equity in any option that lapses if such Authorization is not so received.

**CONTRACT ORIGINAL (a)**

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & CO.,

Plaintiffs,

76 Civ. 5124

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION: JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION: READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs,

MEMORANDUM AND ORDE

76 Civ. 2250

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.

KNAPP, D.J.

Plaintiffs British American Commodity Options Corporation, Lloyd, Carr & Company, and the National Association of Commodity Option Dealers, et al.,[1/] seek both injunctive and declaratory relief to restrain the defendants, Commissioners of the Commodity Futures Trading Commission (hereinafter "the Commission"), from enforcing regulations concerning commodity option transactions published in the Federal Register on November 24, 1976 of which part went into effect on December 9, part is to go into effect on December 27, and the balance is to go into effect on January 17, 1977. 41 Fed. Reg. 51808. Plaintiffs have moved for a preliminary injunction, and defendants have cross-moved for summary judgment. For the reasons which follow, we in part grant and in part deny defendants' motion for summary judgment; and we grant plaintiffs' motion for a preliminary injunction with respect to the portion of the regulations which is to take effect on December 27, 1976, and otherwise deny such motion.

The jurisdiction of this court, which the defendants have not contested, is premised on 5 U.S.C. §701 et seq., 7 U.S.C. §3, 28 U.S.C. §1331, 28 U.S.C. §1337, 28 U.S.C. §2201 and §2202.

The plaintiffs are dealers in "options" in certain commodities trading on certain exchanges in London, England. That is to say they sell their U.S. customers options to buy futures contracts traded on those exchanges. They mount a wide variety of attacks upon the rules and regulations of the Commission. We find only one of these to have merit, and the major part of this opinion will be devoted to explaining our difficulty with that regulation. Thereafter we shall briefly deal with plaintiffs' other criticisms. The regulation as to which we find the complaint to have merit is the one, effective December 27, 1976, which requires plaintiffs to segregate 90% of the price their customers pay them for the options. In view of the circumstance that the nature of plaintiffs' business - in which they act as agents for London principals - requires them to immediately transfer to London about 75% of such purchase price, we find this segregation requirement to be a hardship which - as we sha develop - the Commission does not seem to have adequately justified.

## FACTS

On October 23, 1974 the Congress enacted the Commodities Futures Trading Commission Act of 1974 (hereinafter "the 1974 Act"). 88 Stat. 1389. This Act in effect constituted a series of amendment to the Commodity Exchange Act, which had initially been enacted in 1936. The 1974 Act created the Commission as an independent federal regulatory agency, and referred to it certain regulatory functions previously within the jurisdiction of the Department of Agriculture. The Act further vested the Commission with additional authority.

As enacted in 1936, the Commodity Exchange Act set up methods of regulating trade in contracts of sale for future delivery of certain commodities ("futures"). That Act also prohibited tradin in "options" with respect to the commodities regulated.[2/] The 1936 Act covered only specifically designated commodities.[3/] The 1974 Ac expanded the definition of commodities subject to regulation to incl virtually all previously unregulated commodities, by bringing within its scope all "goods and articles . . . and all services rights and interests in which contracts for future delivery are presently or in the future dealt in . . ."[4]

With respect to the commodities previously regulated, the 1974 Act continued the absolute prohibition on trading in options.[5] However, with respect to trading in options in the newly covered commodities, the 1974 Act authorized the Commission either to extend the absolute prohibition to such trading or to subject it to regulation.[6]

The plaintiffs in this action deal in "options" in previously unregulated commodities[7] and challenge the regulations the Commission has imposed upon them pursuant to the 1974 Act.

So far as here relevant, the pertinent statute provides:

> "No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a) of this Act, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets."[8]

Legislative History of the 1974 Act

The Congressional decision to expand the commodities subject to regulation arose out of the financial failure of at least one company, Goldstein, Samuelson, Inc. which sold options in the unregulated commodities for which no underlying futures contract had been purchased so that customers who tried to exercise their options were defrauded. Congressional hearings focused on this scandal.[9]

This led the House of Representatives to first consider a bill which expanded the commodities subject to regulation and extended the prohibition on trading in options to all these commodities. H.R. 11955.[10] However, following hearings at which several witnesses testified that options trading might be economically useful and that regulations could be devised to protect option purchases,[11] the House introduced a new bill, H.R. 13113, which authorized the Commission to decide whether to ban or regulate option trading in the newly regulated commodities. This section of H.R. 13113 is substantially the same as that finally enacted into law and reads as follows:

> "No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a)(1) of this Act, prior to the enactment of the 'Commodity Futures Trading Commission Act of 1974', which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission may prescribe: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And

> provided further, That the Commission may set different terms and conditions for different markets."

The House report on this portion of the bill states:

> "Options Trading (Section 402)
> The discretionary authority granted the CFTC to regulate or ban trading in options in commodities . . . is not to be exercised by the Commission to approve any transaction of the character of, or commonly known as an 'option', . . . if the option or transaction named does not guarantee the purchase of the futures contract in fulfillment of the option, should the purchaser seek to exercise the option. The Committee intends the Commission act as expeditiously as possible to prohibit such transaction."12/

The Senate amended this portion of the House bill to require the Commission to prescribe regulations governing options within one year after the effective date of the bill and to clarify the jurisdiction of the Commission relative to that of other regulatory agencies. The Senate otherwise retained the language of the House bill. The Senate Committee report on which the Senate had acted stated:

> "The Committee intends that options not be traded except on organized exchanges and in conformity with the rules and regulations of the Commission."13/

The Conference Committee report does not contain any reference to any limitation on the scope of the Commission's discretion. The Conference substitute embodied the House provision as amended by the Senate with a further amendment which according to the Conference report provided that:

> "The period for issuing regulations governing such options trading may be extended if the Commission determines, and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture, that it will be unable to promulgate such regulations within" the one-year period.14/

Both Houses adopted the Conference substitute which became §4c(b) of the Commodities Exchange Act. Under this statutory provision, option dealers in commodities not regulated prior to 1974 could continue to do business in their accustomed manner until the Commission - by regulations promulgated after notice and opportunity for hearing - either required them to do otherwise or prohibited trading in options.

History of this Rulemaking

On April 25, 1975 the Commission published its first set of proposed rules pursuant to §4c(b). 40 Fed. Reg. 18187. Terme "antifraud rules", these were designed to prevent deceptive practic in connection with the sale of commodity options. The Commission adopted these in amended form on June 24, 1975 to take effect immediately. 40 Fed. Reg. 26504.[15]

On October 22, 1975 the Commission published notice that it was "considering the adoption of further rules to regulate - or perhaps forbid - transactions in commodity options". 40 Fed. Reg. 49360. The regulations ultimately adopted by the Commission pursuant to this rulemaking are those challenged in the instant action. The basis and purpose for considering rules additional to the antifraud rules was stated to be:

> "Commodity-option offerings appear to have proliferated, and many of these offerings appear questionable since in most cases investors are not given adequate assurance that the issuers of the options will be able to perform their obligation under the option contracts when and if required to do so."
> 40 Fed. Reg. 49360

The broad alternatives under consideration included: prohibiting all commodity option transactions, restricting these to contract markets, allowing only those sold in accordance with a "business plan" approved by the Commission and/or allowing only those sold by persons registered with the Commission. The Commission assigned to an Advisory Committee the responsibility of making recommendations to the Commission. 40 Fed. Reg. 49360. This Advisory Committee was composed of fourteen persons. Two were Commissioners of the five-member Commodity Futures Trading Commission.[16] The remaining twelve were mainly from law firms and private industry.[17]

The Commission invited the public to submit comments to both it and the Advisory Committee on these broad alternatives and specific enumerated issues. The concept of segregation was not specifically mentioned at this time. The Commission further stated that pending receipt of the Advisory Committee's recommendations and digestion of public comments it might adopt temporary rules without further public notice should it find these urgently necessary "to protect the public".

After considering the comments submitted in response to its October 22, 1975 notice, the Commission published proposed rules for comment on February 20, 1976. 41 Fed. Reg. 7774.[18] It proposed that all commodity option dealers be required: to register with the Commission as commodity option dealers, to file a disclosure statement with the Commission and inform each customer such was publicly available at the Commission, and to meet minimum financial standards (that assets exceed liabilities and that "net working capital" exceed

$100,000 excluding the premiums received from customers).[19/] Commodity option dealers who failed to meet these requirements would be prohibited from trading in options.

However, the Commission stated it would entertain requests for exemptions from the net working capital requirement from those commodity option dealers "who act solely on an agency basis for other dealers who issue or assume full financial responsibility for the commodity option transaction" since it recognized that the requirement "may be inappropriate" for these agent dealers.[20/]

The Commission further stated it had decided not to require commodity option dealers to segregate funds received from customers until the option was exercised or expired "because of inherent difficulties of ascertaining which dealer should segregate (i.e., the problem of double segregation)".[21/] Nonetheless the Commission stated it was "particularly interested in receiving comments as to whether such a requirement could and should be imposed".[22/]

In addition the Commission stated that after it received the Advisory Committee report and comments to these proposed rules:

> "the Commission will determine whether it will require additional time to study the recommendations and comments in order to evaluate the extent to which they should be included as part of a permanent regulatory program. If the Commission believes that such additional time is required, the proposed rules may be adopted as interim and temporary rules only." 41 Fed. Reg. 7774.

After publication of these proposed rules, the Commission received many comments, and on March 8, 1976 it held a public

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hearing. On July 6, 1976 it received the report from its Advisory Committee.

The Chairman of the Advisory Committee, who also was the Vice-Chairman of the Commission, prefaced this report with the question "Commodity Options in the U.S.: What test?" He stated "The statute, itself, is silent." However, he noted that the Act includes standards guiding Commission regulation of futures and that:

> "It has been suggested that the Commission apply the same test for options that it applies for futures contracts, i.e., that 'they not be contrary to the public interest . . . I suggest the Commission require that proponents of option trading should be prepared to meet requirements and procedures similar to those required by the Commission for futures trading on contract markets which are designated by the Commission."23/

The Advisory Committee followed its Chairman's suggestions and recommended to the Commission that options dealers should be subject to the same basic requirements that are imposed on futures merchants. One of the requirements it therefore recommended was that options dealers segregate funds received from customers.24/

The Advisory Committee did not indicate whether or not it had taken into account the circumstance that options dealers - who act as agents and have to forward to their principles funds received from customers - would find this segregation requirement more burdensome than futures dealers who act as principals for their own account. They did, however, state the recommendations were tentative and preliminary since the area of commodity option trading was complex and the data on which the recommendations were based was inadequate.25/

On October 8, 1976 the Commission published a modified version of its February proposals which it termed "proposed interim regulations" to take effect November 22, 1976. 41 Fed. Reg. 44560. It also invited comment as to whether these should be modified prior to their adoption.

The reason given for adopting these as "interim regulations" was that the Commission planned in 90 days to put into effect a second stage of regulations. The Commission described this proposed second stage as:

> "comprehensive regulations for a limited, rigidly-controlled three-year (or shorter) test program that ultimately will require commodity options to be purchased and sold on or through the facilities of Commission-designated boards of trade . . ."

The Commission further stated:

> "The test program will be designed to determine the nature and extent of the impact of commodity option trading on the underlying futures and cash markets, the economic utility of commodity option trading and the capability of the exchanges to conduct adequate market surveillance and to assure orderly markets . . . the test program will enable the Commission to obtain sufficient data on which to have a permanent regulatory program concerning commodity options or, if necessary, to determine to prohibit trading in commodity option[illegible] the United States."
> 41 Fed. Reg. at 44560.

Among the interim regulations proposed to take effect in November, 1976 was §32.6 which provided for segregation.[26] In proposing this regulation the Commission recognized that it might cause hardship, especially to those who - like plaintiffs - act as agents for members of London exchanges. Thus the Commission observed:

> "The Commission is aware that proposed § 32.6 may, in certain cases, require 'double segregation.' For example, in the case of the sale of London options, a person receiving the funds from an option customer in the United States as payment for the option may not remit those funds to London in order to obtain or maintain the option position with a London broker. The Commission believes that the proposed segregation requirements are an essential customer protection to be afforded commodity option customers in the United States. The Commission recognizes, however, that its proposed segregation requirements may impose a financial hardship on some affected persons." 41 Fed. Reg. 44562.[27]

The Commission accordingly requested comments and suggestions for viable alternatives.

After receiving several comments, the Commission published revised rules on November 24, 1976, which are those now under challenge. 41 Fed. Reg. 51808. Insofar as concerns segregation, the Commission revised the amount to be segregated, reducing it from 100% of the funds received from customers to 90% of those funds.[28] Despite this reduction the Commission reiterated its recognition that adoption of this segregation requirement might impose hardship, "particularly with respect to the sale of London options", but simply stated that no acceptable alternative susceptible of immediate implementation had been suggested. Thus the Commission observed:

> "Several commentators have indicated that letters of credit, bonding requirements, and other forms of financial guarantees could be used as alternatives to segregation. While the Commission believes that these suggestions are on the whole constructive, and while the Commission would urge continued efforts by commentators to suggest suitable alternatives to the segregation requirement, specific proposed alternatives have not yet been submitted which would be capable of being effectuated to coincide with the adoption of the interim rules. Accordingly,

> the Commission has determined to include segregation requirements in the interim rules as adopted..."41 Fed. Reg. 51812

The Commission did indicate that it would consider applications for exemption from the segregation requirement, but made quite clear that it would subject such applications to rigorous scrutiny, and that exemptions would be granted only if "the Commission finds, in its discretion, that it would not be contrary to the public interest to grant such exemption." 41 Fed. Reg. at 51812.

## DISCUSSION

With respect to the regulation requiring segregation, the essential facts are that as first proposed in February, 1976, the rules contained no such requirement. The Commission then specificall noted that such a requirement might well be inappropriate for some option dealers. In July, the Advisory Committee specifically noted that the underlying statute provided no standards to guide its determination. Indicating that it would look for guidance to the standards and methods used in regulating dealers in futures contracts it recommended that option dealers be required to segregate. There i nothing in the Advisory Committee report to suggest that it had considered whether such a requirement - which had originally been devise to apply to dealers in futures contracts who normally act as principals - could be appropriately applied to option dealers who, like plaintiffs, act only as agents.

Acting on the Advisory Committee's report and other comments, the Commission in October for the first time proposed a ru requiring segregation, specifically calling attention to the hardshi involved and calling for the suggestion of alternatives. Having rejected all alternatives which were suggested on the ground they were not susceptible of immediate implementation, the Commission in November announced adoption of its interim segregation rule - to take effect December 27, 1976.

The only reason stated for this admittedly harsh action was the need for speed to protect the public. The Commission does not cite, and we cannot find, any reason or fact which had come to its attention since the rules were proposed in February without any provision for segregation which would seem to justify this need for haste.[29 /] Such haste seems especially unjustified in view of the admittedly harsh consequences of the rule and the Commission's continuing search for alternatives. In the circumstances, we must conclude that plaintiffs have a reasonable likelihood of success in establishing that defendants acted arbitrarily and capriciously in imposing segregation requirements - at least as applicable to option dealers, who, like plaintiffs, act only as agents. See e.g., National Nutritional Foods Association v. Weinberger (2d Cir. 1975) 512 F.2d 688, 701, cert. den. 423 U.S. 827.

Although it has not been claimed that the authority granted the Commission pursuant to §4c(b) constited an invalid delegation of authority because of the Congress' failure to provide any standards to guide the Commission, we do note that the Commission's Vice-Chairman has specifically observed that the statute is silent on the matter of standards. See p. 10, supra. Whether or not such failure to provide standards could be said to invalidate this portion of the legislation (compare Panama Refining Company v. Ryan (1936) 293 U.S. 388 and Wright, Beyond Discretionary Justice, 81 Yale L.J. 575 (1972) with Davis, A New Approach to Delegation, 36 U. Chi. L.R. 713 (1969)), such failure should at least be deemed to impose on the Commission the obligation of taking particular pains to ensure that its rulemaking will not be arbitrary and capricious. See Davis op. cit., supra.

Therefore, with respect to the regulation requiring segregation, it is our conclusion of fact that plaintiffs are threatened with irreparable injury in that, being required by the necessities of their business to forward to their principals in London the premiums for options they sell to their customers (representing at least 75% of the funds received from customers), they could not long remain in business if required to segregate in the United States an amount equal to 90% of such funds.[29a/] It is our conclusion of law that - for the reasons above outlined - plaintiffs have a reasonable likelihood of success on the merits of their attack on the segregation requirement. We further conclude, in light of the wide panoply of regulations already and about to be in effect, that the public interest will not be adversely affected by preliminarily enjoining these segregation requirements.

In addition to the above discussed claim with respect to segregation, plaintiffs British American and Lloyd, Carr put forth a wide variety of contentions as follows:

1. defendants violated the Administrative Procedure Act (A.P.A.) 5 U.S.C. §553 by failing to give an opportunity for meaningful public comment on the rules published November 24, 1976 and by publishing a portion of these rules to be effective in less than 30 days without good cause.

2. defendants' actions are unsupported by substantial evidence in violation of 5 U.S.C. §706(E).

3. the minimum financial and the disclosure requirements adopted are arbitrary and capricious in violation of 5 U.S.C. §706(2)(A).

4. the defendants acted in excess of their statutory jurisdiction under the Commodities Exchange Act §15 7 U.S.C. §19 in that the regulations promulgated are anti-competitive.

([illegible])

5. the defendants acted "without due process as guaranteed by the Fifth and the Fourteenth Amendments to the Constitution since the defendants are not authorized to put the plaintiffs out of business through the imposition of rules". 30/

We find none of these to have merit.

With respect to the claim that defendants violated the Administrative Procedure Act, 5 U.S.C. §553 by promulgating rules November 24, 1976 which allegedly were substantially different from earlier rules without having given the public the opportunity for meaningful comment thereon, we find the Commission provided adequate notice of each of the provisions now contained in its rules and adequate opportunity to comment thereon. To meet this section of the A.P.A., which requires the agency to give notice of proposed rules and to give interested persons an opportunity to participate in the rulemaking, it is sufficient that the proposed rules to which comments are addressed give reasonable notice of the subjects and issues. The Administrative Procedure Act does not require that the rules adopted be identical to those proposed. California Citizens Band Association v. United States (9th Cir. 1967) 375 F.2d 43.

With respect to the claimed violation of §553(d) - in that a portion of the Commission's rules published November 24, 1975 were to take effect less than 30 days thereafter, we find the Commission adequately stated and published good cause for its action.[31/] Thus, it met the terms of the exception to the requirement of 30-day publication found in subsection (3) of §553(d).[32/]

Plaintiffs' claim that defendants' actions are unsupported by substantial evidence cannot be considered. 5 U.S.C. §706(E) makes it clear this standard of review is applicable only to rulemakings pursuant to 5 U.S.C. §556 and §557. The rulemaking here involved was not required to be conducted pursuant to those sections of the Administrative Procedure Act since the Commodities Exchange Act §4c(b) does not require these hearings to be "on the record." Section 4c(b) of the Act requires only that regulations concerning options be made "after notice and opportunity for hearing."

One of the attacks upon the minimum financial requirements as arbitrary and capricious rests on the theory that the segregation requirements will unduly deplete plaintiffs' assets and thus prevent them from meeting the minimum financial requirements. That argument has been disposed of by our ruling with respect to segregation. At oral argument we were persuaded that the other arguments against the minimum financial requirements were grounded upon a misunderstanding of the Commission's regulations.

The claim that the disclosure requirements are arbitrary and capricious also rests on plaintiffs' erroneous reading of the regulations. We accept the Commission's representation at oral argument that plaintiffs are not required to specify the exact results of currency fluctuations and other items not susceptible of knowledge at the time of a sale, but ~~we~~are required only to list and explain such uncertainties. In connection with price items, the requirement is to explain the elements and the method of calculation. The disclosure requirements otherwise appear to us to not be arbitrary or discriminatory.

The claim that the Commission failed to adopt the least anti-competitive means and that this violates the Commodities Exchange Act §15, 7 U.S.C. §19 (Supp. V., 1975) raises no question for us to review. The section cited does not require the Commission to adopt the least anti-competitive means, but only requires it to

> "take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation . . ." (emphasis supplied).

not our position

Plaintiffs have shown us no reason to challenge the Commission's statement that it did consider the anti-competitive impact of various alternatives. 41 Fed. Reg. 51809.

In view of our decision with respect to the segregation requirements, the claim that defendants acted without due process "since the defendants are not authorized to put the plaintiffs out of business through the imposition of rules" can be dismissed since plaintiffs are not in danger of being put out of business. 33/

In addition to the claims made by the original plaintiffs the National Association of Commodity Option Dealers has claimed that the requirement that option dealers register as "futures commission merchants" is in excess of statutory authority because the Commodities Exchange Act specifically defines futures commission merchants as "individuals . . . engaged in . . .[the] sale of any commodity for future delivery on or subject to the rules of a contract market . . . ."[34/] The Commission has itself answered this in the Federal Register notice of November 24, 1976:

> "One commentator suggested that the Commission's determination to make it unlawful for persons to accept money and other funds from option customers unless registered as futures commission merchants was, in effect, an amendment of the Act's definition of a futures commission merchant. The Commission disagrees. Persons who come within the definition of futures commission merchant in section 2(a)(1) of the Act are required to register as such thereunder. The Commission's adoption of the interim rules in no way alters that obligation and in no way alters the definition of futures commission merchant contained in the Act. Rather, as the Commission stated at the time of its October 8, 1976 proposal, the Commission has determined, pursuant to its plenary power to regulate commodity option transactions, to entrust options activities only to persons who meet the basic financial and other requirements of futures commission merchants and associated persons of specified futures commission merchants under the provisions of the Act and the regulations promulgated thereunder."

We think this adequately disposes of the argument.

## CONCLUSION

On the basis of the foregoing we deny plaintiffs' motion for a preliminary injunction except as it applies to that portion of its rules requiring segregation (§32.6). With respect to that requirement, the defendants are preliminarily enjoined from enforcing it against any plaintiff who is in the business of selling options as an agent.

The defendants' motion for summary judgment is denied with respect to the said requirement of segregation, and is otherwise granted.

Settle order on notice.

Dated: New York, New York
December 21, 1976.

WHITMAN KNAPP, U.S.D.J.

# FOOTNOTES

1/ The National Association of Commodity Option Dealers, et al. filed its complaint in the District Court for the District of Columbia, and the case was assigned to Judge Robinson, 76 Civ. 2250. Upon hearing that the issues had already been presented to this court and might be decided here first, they consented to a change of venue. They then appeared and argued at the hearing on the instant motions held in this court on December 10, 1976. Judge Robinson granted a change of venue to this court on December 14, 1976. Plaintiffs then moved to consolidate their complaint with that of plaintiffs British American and Lloyd, Carr. We hereby grant that motion.

2/ A commodity option gives the purchaser the right, during a specified period of time, to buy ("call") and/or sell ("put") at a set price a specific futures contract or, in the case of an option on an actual commodity, a specific quantity of that commodity. In the case of so-called "London options" of the type offered by plaintiffs here, the option relates to futures contracts on commodities traded on the London commodity markets.

3/ Commodities Exchange Act §2(a), 7 U.S.C. §2. The number of commodities regulated increased from time to time after 1936. See the Advisory Committee Report to the Commission, July 6, 1976 ("the Advisory Committee Report"), p. 96, n. 37.

4/ Commodity Futures Trading Commission Act of 1974, §201, Section 2(a) of the Commodities Exchange Act as amended, 7 U.S.C. §2 (Supp. V, 1975).

5/ Commodity Futures Trading Commission Act of 1974 §402, Commodities Exchange Act as amended, §4c(a), 7 U.S.C. §6c(a) (Supp. V, 1975).

6/ Commodity Futures Trading Commission Act of 1974, §402, Commodities Exchange Act as amended, §4c(b), 7 U.S.C. §6c(b) (Supp. V, 1975). The 1974 Act also gave the Commission exclusive jurisdiction to regulate these. Commodities Exchange Act §2(a)(1), 7 U.S.C. §2 (Supp. V, 1975).

7/ Plaintiffs British American and Lloyd, Carr act as agents for others who write options on two London exchanges.

8/ The 1974 Act §402, the Commodities Exchange Act as amended §4c(b), 7 U.S.C. §6c(b) (Supp. V, 1975).

9/ Plaintiffs state the Congress focused on only one large failure which defrauded customers, whereas defendants maintain it focuse on several. Defendants brief on summary judgment, p. 7.

Congressional hearings documented that Goldstein Samuelson, Inc. had started business with a thin capital base, and had conducte business by collecting premiums from unsophisticated investors and using these to pay off the customers who exercised their options. The company had obtained few futures contracts to "cover" or "hedge" their obligations because futures contracts are relatively more expensive than the premiums received, and - as noted before, the company had little capital above and beyon the premiums received. The company expected to make a profit o the theory few customers would exercise their options because they would have incorrectly guessed market movements, and therefore enough money would be left from customer premiums to repay the few who exercised. Ultimately, when too many customers tried to exercise their options, the company defaulted on its obligations, went bankrupt and many customers were deprived of the benefit of their bargain. Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 181-182, 194-196 (1974); see also Hearings on S. 2485 S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess. pt. 1, at 224-225 pt. 3, at 682-683, 824-25, 830-835 (1974).

10/ House Committee on Agriculture Report on the Commodities Future Trading Commission Act of 1974, H.R. Rep. No. 975, 93d Cong., 2d Sess. 36-37 (1974).

11/ Hearings on H.R. 11955 before the House Committee on Agricultur 93d Cong., 2d Sess. at 37, 40-41, 176-180, 199, 251, 329 (1974) see Advisory Committee Report, p. 98.

12/ H.R. Rep. No. 975, 93d Cong., 2d Sess. 31 (1974).

13/ S. Rep. No. 1131, 93d Cong., 2d Sess. 26 (1974).

14/ H.R. Rep. No. 1383, 93d Cong., 2d Sess. 40 (1974). The full te of the Joint Explanatory Statement of the Committee of Conferen on this portion of the bill states:

> "(16) Options trading.
> The House bill continues the ban now contained in section 4c of the Act on trading in options (privileges, indemnities, bids, offers, puts, calls, advance guaranties, and decline guaranties) in the now-regulated commodities, but permits trading in options in all other commodities if not done contrary to any rule, regulation, or order of the

> Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission may prescribe. The Commission could promulgate such an order, rule, or regulation only after notice and opportunity for hearing. The Commission may set different terms and conditions for different markets.
>
> The Senate amendment retains the House provision, but provides that the Commission is to prescribe the regulations governing such options trading within one year after the effective date of the bill.
>
> The Conference substitute adopts the Senate provision with an amendment providing that the period for issuing regulations governing such options trading may be extended if the Commission determines, and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture, that it will be unable to promulgate such regulations within the one-year period."

15/ The Commission brought an injunctive action to restrain violations of these sections. Commodities Futures Trading Commission v. J.S. Love & Associates Options, Ltd., (S.D.N.Y.. 1976) ¶20,198, CCH Comm. Fut. L. Rptr. Judge Bonsal denied injunctive relief because there was no likelihood the practices he found to be deceptive would be repeated. See also Commoditie Futures Trading Commission v. British American Commodity Options Corp. (S.D.N.Y. 1976) ¶20,224 CCH Comm. Fut. L. Rptr., J. Gagliardi.

16/ John Rainbolt, the Vice-Chairman of the Commission, was Chairma of the Advisory Committee and William Bagley, the Chairman of the Commission, was an ex-officio member of the Advisory Committe

17/ For biographies of the members of this Advisory Committee. see the Advisory Committee Report, p. 174f.

18/ The Commission had not yet received the report of its Advisory Committee.

19/ See 41 Fed. Reg. at 7778 for further definition of the exclusio and inclusions to the net working capital requirement.

20/ Plaintiffs are agents for others who write options on two London exchanges. Plaintiffs have claimed that their principals are required to assume the full financial responsibility for the option transaction.

21/ By this statement the Commission may have meant that in those situations where an option dealer acts as an agent, whose only obligation is to transfer customer premiums to the option write it might not be appropriate to require such agent to "segregat the premium he was already obliged to transfer to another.

22/ The Commission also requested comments as to whether it should require option dealers to deliver disclosure statements to prospective customers in advance of any option transaction, and whether it should permit commodity options to be traded on contract exchanges and ultimately restrict option trading to such exchanges.

23/ Advisory Committee Report, p. xv-xvi. This report was transmitted to the Committee on July 6, 1976 and published as a special supplement to the CCH Commodity Futures Law Reporter on July 15, 1976.

24/ Id., p, 18, 30, 47-48. The Advisory Committee recommended requiring dealers to segregate that portion of the customer's funds which represented the premium paid for the option right, leaving the dealer free to use that portion representing his costs and commission. It did not suggest specific percentages

25/ Id. pp. vi, xiii

> "While it is not, and was not intended to be the 'ultimate' study on the subject (which must of necessity await more definitive data), its undertaking was suggested as an initial step in dealing with the issues posed by §4c(b) of the Commodities Exchange Act Id., p. vi . . .
>
> "There are limits to the use of the Advisory Committee forum itself, especially in an area as complex as commodity option trading, where the lack of needed data regarding the subject hampered the Advisory Committee's inquiries." Id., p. xiii

26/ This proposed regulation provided that the option dealers who were required to register must segregate 100% of the funds received from customers. 41 Fed. Reg. at 44567.

27/ Thus, these Commission rules would require agent option dealers such as plaintiffs to keep the customer's funds segregated in the United States, thereby requiring them, in turn, to obtain additional funds to remit to London in order to obtain the opt position.

In addition, we note that plaintiffs have claimed that their principals in turn, are required by the London exchanges of which they are members to segregate all customer premiums so that the agents' customers will be protected. The Commission has disputed this claim, citing the Advisory Committee Report, pp. 41-42, 130-139.

28/ See the memorandum of the National Association of Commodity Op Dealers in support of the complaint, Exhibit III, for excerpts of the minutes of the Commission's meeting at which the reduct from 100% to 90% was approved.

29/ Although the Commission appears to justify such haste by adverting to the Congressional directive in §4c(b) that it promulgate rules with respect to options within one year, we note that the Conference Committee amendment which was emobidi in the final version of the bill provided an exception to this requirement if the Commission determines and notifies both Houses of Congress "that it is unable to prescribe such terms and conditions within such period." We further note that the Commission did promulgate one set of rules concerning option transactions, the antifraud rules, within the one year period. In addition, on October 8, 1976 the Commission stated: at 41 Fed. Reg. 44560, n.5:

> "Section 4c(b) also provides that, if possible, rules were to be adopted within one year after the effective date of the section. However, the Commission advised Congress, in accordance with the provisions of section 4c(b), that it would be unable to meet the one-year time period ending April 21, 1976, within which to have comprehensive commodity option regulations in effect and that additi al time would be required to carry out the Congression mandate contained in section 4c(b)." See 41 FR 16885 (April 21, 1976)

29a/ The Commission's suggestion that this could be accomplished by bank financing is not persuasive.

30/ Amended Complaint ¶8b, p.4.

31/

The Commission stated:

> "The Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof." 41 Fed. Reg. at 51817. See also 41 Fed. Reg. at 51810, column 1.

32/

In fact, most of the changes relieved prior proposed restrictions thus meeting the terms of another exception to 30-day publication, that stated in subsection (1) of §553(d).

33/

In addition, we note that §4c(b) of the Commodities Exchange Act does authorize the defendants to prohibit trading in options provided the defendants act by rule or order after notice and opportunity for hearing.

34/

Section 2(a)(1) of the Commodities Exchange Act, 7 U.S.C. §2. We note that the Commission has previously taken the position that other provisions of the Commodities Exchange Act which use the language "commodities for future delivery on or subject to the rules of a contract market", for example §4b, "may not apply to option transactions since these transactions are not made 'on or subject to the rules of any contract market.'" 40 Fed. Reg. 18188 (April 25, 1975).

## ORDER AND JUDGMENT

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION: JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION: READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.

ORDER & JUDGMENT

76 Civ. 5124 (Knapp)

(Consolidated)

This cause came on for hearing on December 10, 1976, on plaintiffs' motion for an order preliminarily enjoining the defendants, who are the members of the Commodity Futures Trading Commission, from implementing or enforcing regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, and on ~~the~~ defendants' cross-motion for summary judgment, pursuant to Rule 56 of the Federal Rules of Civil Procedure. The Court having heard the argument of counsel and having considered the affidavits, exhibits and legal memoranda in support of the motions and in opposition thereto and all other papers heretofore filed in the case, and due deliberation having been had thereon, it is hereby W

ORDERED, that the defendants, their officers, agents, servants, employees and attorneys, and those persons in active concert or participation with them who receive actual notice of this order, be and they hereby are PRELIMINARILY enjoined, during the pendency of this action, from enforcing the segregation requirements contained in Section 32.6 of said regulations against any plaintiff who is in the business of selling options as an agent for a ~~London~~ principal; and it is further K

W.K.

ORDERED that defendants' motion for summary judgment is in all respects granted except with respect to the segregation requirements set forth in Section 32.6 of said regulations, and, there being no just reason for delay, judgment is hereby directed to be entered in favor of the defendants on all issues other than the enforcement of Section 32.6.

Dated: January 3, 1977
New York, NY

Whitman Knapp
U.S.D.J.

JUDGMENT ENTERED -

CLERK

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

---

BRITISH AMERICAN COMMODITY OPTIONS
CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the
COMMODITY FUTURES TRADING COMMISSION;
JOHN V. RAINBOLT III, Vice Chairman
of the COMMODITY FUTURES TRADING
COMMISSION; READ P. DUNN, GARY
SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES
TRADING COMMISSION,

Defendants.

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MOTION FOR STAY PENDING
APPEAL OR IN THE ALTERNATIVE, RECONSIDERATION
OF CERTAIN PORTIONS OF
THE COURT'S RULING OF
DECEMBER 21, 1976

76 Civ 5124 (Knapp)

Upon the amended complaint and all the affidavits and other papers filed, and all the proceedings heretofore had herein, and the affidavit of Charles J. Hecht, Esq., with exhibits attached hereto, the plaintiffs move the Court for an order staying the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing certain portions of the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, pending the hearing and determining of plaintiffs' appeal to the United States Court of Appeals, Second Circuit from the order of this Court entered December , 1976, or in the alternative reconsideration of those portions of the Court's ruling dated December 21, 1976 relating to the rules

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

---

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

AFFIDAVIT

76 Civ 5124 (Knapp)

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CHARLES J. HECHT, being duly sworn, deposes and says:

1. I am the attorney for the plaintiffs in the above proceeding, which was subsequently consolidated with an action entitled National Association of Commodity Option Dealers et. al v. The Commodity Futures Trading Commission et al, 76 Civ 2250 (D.C., Dist. of Col.) and am thoroughly familiar with all the facts and circumstances thereof. I make this affidavit in support of plaintiffs' motion for an order staying the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing those regulations pending an appeal by plaintiffs to the United States Court of Appeals for the Second Circuit, from the order of this Court dated December , 1976, denying

on minimum financial requirements (Section 32.3 and Rule 1.17) and registration (Section 32.3 and Rule 1.19), and for such other and further relief as to the Court may seem just.

Dated: December 30, 1976

Charles J. Hecht
Attorney for Plaintiffs
British American Commodity
Options Corp. and
Lloyd, Carr & Co.
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Of Counsel: Haig Costikyan

plaintiffs' application for a declaratory judgment declaring null and void the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, or in the alternative, for a preliminary injunction preventing the implementing or enforcement of said regulations, except as to Section 32.6 thereof as to which the Court granted plaintiffs a preliminary injunction.

2. On December 22, 1976, the defendants issued a press release, copies of which are annexed hereto as Exhibits "A" and "B", stating that they would move this Court for reconsideration of its rulings with respect to Section 32.6 ("double segregation"). These releases, amongst other things, also set forth the defendants' threat to ban commodity options altogether if the Court does not change these rulings. Their attitude is a flagrant insult to the integrity of this Court and the entire judicial system.

3. There is a strong likelihood that the plaintiffs will prevail on the merits on the appeal to be prosecuted on one or more of the following grounds:

(a) The regulations relating to the minimum financial requirements, registration and disclosure are arbitrary, capricious and unreasonable and violate the due process clause of the Fifth Amendment and certain portions of the Court's rulings with respect thereto were based upon oral representations of counsel for the defendants which are directly contrary to the actions of the defendants and other rules and regulations promulgated by the defendants.

(b) The actions of the defendants in promulgating said regulations were unlawful within the meaning of 5 U.S.C. §706(2)(A) et seq.;

(c) The actions of the defendants in promulgating said regulations violated the provisions of 5 U.S.C. 553(d); and

(d) The evidence is insufficient to support a finding of substantial harm to any interested person if the stay is granted or that the continuation of plaintiffs' business pending appeal would cause harm to the public interest.

4. It is respectfully submitted that the Court erred as to its ruling on the minimum financial requirements because the defendants' counsel misinformed the Court in its brief and at oral argument and the Court specifically based its ruling on such information. Reg. 1.17 specifically provides that aggregate indebtedness shall exclude 5% of customer's equity only if the customer's funds are segregated. Opposing counsel's brief states:

> "[P]laintiffs have erroneously included the unrealized value of their customer's outstanding option positions in their computation of aggregate indebtedness . . . For the same reasons the allegations in Section 8(a)(ii) of the Amended Complaint regarding "conflicts of interest" are without foundation." at p. 36

5. However, at the same time the defendants', in rejecting applications of other commodity option dealers,

are taking the position that under Reg 1.17 you must not only include 5% of the customer's equity in computing aggregate indebtedness but, since these represent unsecured accounts receiveable from the clearing broker, there is an additional charge against assets equal to 5% of such customer's equity. The affidavit of David Weinlass with a copy of a typical letter is annexed hereto as Exhibit "C". The net effect is a 10% charge, which in the case of the plaintiff British American will range from $250,000 to $1,600,000 based on its past history of operations. Accordingly, since the segregation requirements have been preliminarily enjoined, the dealer is placed in a direct conflict of interest position vis-a-vis the interests of its customers. It is now in the dealer's best interests to have his customers lose their entire investment.

6. Deponent can understand the Court's position that the agency's interpretation of its own rules is presumptively correct. However, the clear wording of Reg. 1.17 and the actual actions of the staff in processing applications, as distinguished from improper arguments utilized to convince the Court to uphold the "reasonableness" of their regulations, which should have been ignored, would have dictated a contrary conclusion. Plaintiffs were correct that the minimum financial requirements, as set forth in said regulations, were designed as an alternative method to put all existing retail dealers in London commodity options out of business in the event the Court voided the segregation

requirements set forth in Section 32.6. Finally, the Court recognized that the plaintiffs act as agents and, therefore, the alternative financial requirements applicable to persons who act as principals (i.e., purveyors of commodity futures contracts) are clearly not applicable for the same reasons that the segregation requirements are not applicable or relevant. Since March, 1976, plaintiff British American has supported a net worth requirement of $50,000 to $100,000.

7. Even assuming arguendo that the defendants' counsel is correct that the minimum financial requirements are not effective until January 17, 1977, and thus plaintiffs are not immediately harmed (footnote 60 at page 36), this is prior to the date a ruling on the improper alternative minimum financial requirements can be obtained on appeal.

8. In addition, it is respectfully submitted that the Court erred in not ruling upon plaintiffs' position in this case that the defendants' refusal to repeal Reg. 1.19, which prohibits futures commission merchants from trading in commodity options, clearly violates 5 U.S.C. §706 (pp. 11 and 12 of Plaintiffs' Memorandum of Law dated November 22, 1976). Whether or not plaintiffs' are labeled an "FCM" or an "OCM" or whatever is irrelevant. What is relevant is that the staff can arbitrarily and capriciously select, without any published standards, who is exempt and who is not exempt. As to British American this permits the staff on January 17, 1977, to unilaterally reverse Judge Gagliardi's

decision, as reported in CCH Fed. Comm. Fut. L. Rep. ¶20,224 and put British American, as well as any other existing commodity option dealer out of business without any due process. Thus, the appeal will become meaningless as to any plaintiff who is arbitrarily denied an exemption from Reg. 1.19.

9. It is respectfully submitted that as to the disclosure and certain other requirements it has never been the plaintiffs' position herein that the defendants did not consider the anti-competitive effects. Just the opposite. Defendants along with other persons not a part of this industry have deliberately imposed disclosure requirements which place retail commodity option dealers at a severe competitive disadvantage to purveyors of futures contracts and CBOE options who are not required to make such disclosures.

10. To further harm plaintiffs' business the defendants have set up a well-publicized hot line to promulgate its drive against commodity options, which to deponent's knowledge has never been done by any governmental agency, and furnishes slanted information to discourage prospective customers from purchasing commodity options. A copy of such information is annexed hereto as Exhibit "D". The Court's attention is directed to Question 10. Both plaintiffs have reported to the undersigned that when potential customers call Merrill Lynch, et al., that they are advising people to buy CBOE options, which they handle, and not London commodity

options, which they do not handle.

11. The material and adverse effect of those new disclosure requirements and the defendants' improper public relations campaign on the plaintiffs' business is shown by the affidavit of John Forma, president of the plaintiff British American, which is annexed hereto as Exhibit "E" and, thus, a stay, as distinguished from reconsideration, as to the disclosure provisions is appropriate.

12. If the said regulations are implemented and enforced irreparable injury will result not only to the plaintiffs but to their employees and customers. If the plaintiffs prevail on appeal, which it is submitted is a strong likelihood, a denial of the instant motion would make the restoration of the status quo impossible, since the plaintiffs' organizations would by that time be decimated and the property rights of plaintiff's customers and employees would be irreparably damaged.

WHEREFORE, it is respectfully requested that the motion for a stay pending an appeal be in all respects granted, or in the alternative, that the Court grant the plaintiffs the original relief requested as to the regulations relating to minimum financial requirements and registration.

Charles J. Hecht

Charles J. Hecht

Sworn to before me this
3rd day of December, 1976

Notary Public

[illegible]
Notary Public, [illegible]
No. 60-077[illegible] Qual. [illegible]
Commission Expires March, 30, 1977

EXHIBIT "A" TO AFFIDAVIT OF CHARLES J. HECHT

CFTC LIKELY TO APPEAL SEGREGATION INJUCTION

WASH--DEC 22--CNS--COMMODITY FUTURES TRADING COMMISSION CHAIRMAN WILLIAM BAGLEY TOLD CNS TODAY THAT, "IN ALL LIKELIHOOD," THE CFTC WILL APPEAL JUDGE WHITMAN KNAPP'S PRELIMINARY INJUNCTION AGAINST IMPLEMENTATION OF CFTC LONDON COMMODITY OPTIONS SEGREGATION RULES.

THE NEW YORK SOUTHERN DISTRICT COURT JUDGE RULED LAST NIGHT TO ENJOIN THE SEGREGATION RULES BECAUSE HE SAYS THE CFTC ACTED IN HASTE IN IMPLEMENTING RULES WHICH IMPOSE "HARDSHIPS" ON FIRMS SELLING LONDON OPTIONS. UNDER THOSE RULES, FIRMS DEALING IN LONDON OPTIONS MUST SEGREGATE 90 PCT OF CUSTOMER MONIES IN LONDON OPTIONS IN A U.S. FUND AS A PROTECTION OF CUSTOMER INVESTMENTS.

BAGLEY SAID KNAPP'S OPINION THAT THE CFTC ACTED IN HASTE IS "FACETIOUS" BECAUSE THE CFTC HAS BEEN TRYING TO SOLVE THE PROBLEM OF PROTECTING CUSTOMER INVESTMENTS IN LONDON OPTIONS SINCE EARLY THIS YEAR. BAGLEY SAID THE CFTC COULD HAVE BANNED OPTIONS TRADING ALTOGETHER BUT INSTEAD ATTEMPTED TO "FIND A WAY TO KEEP THE TRANSACTIONS LEGAL AND AVAILABLE RATHER THAN BAN THEM FROM THE MARKETPLACE."

BAGLEY SAID KNAPP'S DECISION WAS A SURPRISE TO HIM BECAUSE THE CFTC HAS WORKED STRONGLY "FOR SO LONG" FOR A "REASONABLE APPROACH" TO LONDON OPTIONS. BAGLEY SAID THAT WHILE THE CFTC MAY APPEAL THE DECISION, IT IS STILL LOOKING INTO OTHER AREAS FOR CUSTOMER PROTECTION SUCH AS A "CLEARINGHOUSE CHAIN OF LIABILITY" OR A POSSIBLE BANK LINE OF CREDIT WHICH WOULD COVER CUSTOMER MONIES IN LONDON OPTIONS.

MORE

ADD: :15: LIKELY TO APPEAL SEGREGATION INJUNCTION

CFTC VICE CHAIRMAN JOHN RAINBOLT TOLD CNS IT IS "TOO PREMATURE" TO TELL WHAT EFFECT KNAPP'S DECISION WILL HAVE ON THE LONDON OPTIONS INDUSTRY. HE SAID THE DECISION CAME AS A SURPRISE AND THE CFTC PROBABLY WILL APPEAL KNAPP'S DECISION. RAINBOLT ALSO SAID THAT IF THE CFTC SEGREGATION RULES ARE NOT REINSTATED, SOME "DEGREE" OF CUSTOMER PROTECTION BY THE CFTC IS STILL IN ORDER BECAUSE CURRENT RULES "DON'T GET THE JOB DONE" IN PROTECTING THE U.S. CUSTOMER.

ALTHOUGH KNAPP ENJOINED CFTC SEGREGATION RULES, HE DID NOT RULE TO HALT IMPLEMENTATION OF THE BALANCE OF THE CFTC OPTIONS RULES. THE FIRST PORTION OF THOSE RULES WENT INTO EFFECT DEC 9 AND REQUIRE FUTURES COMMISSION MERCHANTS (FCMS) TO REGISTER WITH THE CFTC BY JAN 17. THE RULES ALSO REQUIRE FCMS TO MAINTAIN A 50,000 DLR MINIMUM CAPITAL WORKING REQUIREMENT, AND KEEP AVAILABLE FOR CFTC INSPECTION BOOKS AND RECORDS OF OPTIONS TRANSACTIONS.

THE MOTION TO ENJOIN THE CFTC OPTIONS REGULATIONS WAS BROUGHT BEFORE KNAPP BY THE BRITISH AMERICAN OPTIONS CORP WHICH SAID THAT THE REGULATIONS WOULD FORCE FIRMS DEALING IN LONDON OPTIONS TO GO OUT OF BUSINESS. END

EXHIBIT "A"

EXHIBIT "C" TO AFFIDAVIT OF CHARLES J. HECHT

ADD: CFTC TO ASK FOR RECONSIDERATION OF ENJOINED SEGREGATION RULES

THE CFTC SAID THAT KNAPP'S DECISION UPHOLDS ALL ASPECTS OF LONDON OPTIONS RULES EXCEPT SEGREGATION. BESIDES SEGREGATION OF FUNDS, THE RULES REQUIRE COMMODITY OPTIONS FIRMS TO REGISTER WITH THE CFTC AS FUTURE COMMISSION MERCHANTS (FCMS) AND HAVE A 50,000 DLR MINIMUM CAPITAL WORKING REQUIREMENT.

THE CFTC SAID THAT KNAPP DID NOT DECLARE THE CFTC SEGREGATION RULES INVALID, BUT JUST ENJOINED THE CFTC FROM ENFORCING THE RULE AGAINST THE PLAINTIFFS NAMED IN THE CASE.

THE CFTC SAID THAT COMMODITY OPTIONS TRANSACTIONS ARE PREDICATED ON THE CFTC LONDON OPTIONS RULES AND CUSTOMER PROTECTIONS THEY SET FORTH. THE CFTC SAID DENIAL OF A RECONSIDERATION OR POSSIBLE SUBSEQUENT APPEAL MAY COMPEL THE CFTC; "IN THE PUBLIC INTEREST", TO REEXAMINE CERTAIN FUNDAMENTAL ISSUES, INCLUDING, BUT NOT LIMITED TO, THE RIGHT TO SUSPEND COMMODITY TRADING IN ITS ENTIRETY, LIMITING LONDON OPTIONS TO CLEARING MEMBERS OF THE LCE OR ICCH COMPLEX, "OR OTHER ACTIONS DESIGNED TO LIMIT" CUSTOMER RISK.

END 5:55 O.

---

1 YL SOYBEANS 681-83 1/2 END

CFTC TO ASK FOR RECONSIDERATION OF ENJOINED SEGREGATION RULES

WASH--DEC 22--CNS--THE COMMODITY FUTURES TRADING COMMISSION SAID LATE TONIGHT IT WILL ASK ADMINISTRATIVE LAW JUDGE WHITMAN KNAPP TO RECONSIDER HIS PRELIMINARY INJUNCTION AGAINST CFTC SEGREGATION RULES AFFECTING LONDON COMMODITY OPTIONS.

KNAPP YESTERDAY ENJOINED THE SEGREGATION RULES IN A SUIT BROUGHT TO HIM BY BRITISH AMERICAN OPTIONS CORP; LLOYD CARR AND CO AND NINE MEMBERS OF THE NATIONAL ASSN OF COMMODITY OPTION DEALERS. THE RULES WOULD HAVE REQUIRED OPTIONS FIRMS TO SEGREGATE 90 PCT OF THEIR CUSTOMER MONIES IN LODNON OPTIONS IN A U.S. FUND.

THE CFTC SAID THAT WITHOUT SEGREGATION RULES OR EQUIVALENT ALTERNATIVES, EVENTUAL CUSTOMER PROTECTION WILL NOT BE ESTABLISHED. THE CFTC SAID THAT SHOULD KNAPP DENY ITS MOTION FOR RECONSIDERATION, THE CFTC MAY HAVE TO LOOK INTO THE ENTIRE OPTIONS QUESTION, AND POSSIBLY SUSPEND, U.S. COMMODITY OPTION TRADING, OR LOOK TO ALTERNATIVES SUCH AS ALLOWING U.S. LONDON OPTIONS TRADING WITH MEMBERS ONLY REGISTERED WITH LONDON COMMODITY EXCHANGE OR THE INTERNATIONAL COMMODITY CLEARING HOUSE.

THE CFTC SAID PENDING KNAPP'S DETERMINATION TO RECONSIDER, IT WILL NOT ENFORCE SEGREGATION RULES AGAINST ANY U.S. LONDON OPTIONS DEALER. MORE 5:27 PM

EXHIBIT "B"

EXHIBIT "C" TO AFFIDAVIT OF CHARLES J. HECHT

STATE OF NEW YORK )
COUNTY OF NEW YORK ) ss:

DAVID WEINLESS, being duly sworn, deposes and says:

That he is a Certified Public Accountant, a partner in the public accounting firm of Katz, Zuckerman & Company, (Katz) 50 Broadway, New York, New York 10004;

That Crown Colony Options, Ltd, (Crown) a registered Commodity Trading Advisor, engaged Katz to prepare an unaudited Statement of Financial Condition (Form 1-FR) as of October 31, 1976, which completed form was submitted to the Commodity Futures Trading Commission (CFTC) in connection with Crown's application for registration as a Futures Commission Merchant;

That the CFTC, in a letter to Crown dated December 1, 1976, (a copy of which was furnished to Katz) (Exhibit 1) called attention to the following in the calculation of working capital:

> "1. The audit procedure used by our office in connection with commodity option dealers requires that the gains represented by the excess of the futures contract's market value (which underlines the option contract) over the option contracts striking price, be credited to the customer's equity account and the debit be shown as due from carrying brokers on the London Exchange, whichever is applicable. It appears from an examination of your firm's Form 1-FR that this procedure was not followed. As a consequence, the required 5 percent charge against working capital for the debit amount receivable and the required 5 percent charge for aggregate indebtedness for the amount credited were not taken."

It would appear from the above that the CFTC requires that "equity" in an option customer's account arising from the "mark to market" of the excess of the market value of the futures contract over the strike price of the commodity option be treated as a liability of the option broker-dealer, includible in aggregate indebtedness, and that the contra account with the carrying broker be treated as a current account receivable, and that both the debit amount receivable and the credit customer's equity each give rise to a 5% charge: unadjusted working capital is reduced by 5% of the "carrying broker's" debit account; likewise, the minimum capital requirement is increased by 5% of the increase in indebtedness due to "equity" in option customers' accounts. This is in effect a 10% charge to working capital, and the greater the unrealized appreciation in the customers' option accounts the greater the capital charge (by 10%).

David Weinless

David Weinless

Subscribed and sworn to
before me, this 27th day
of December 1976.

LEONARD SATNICK
Notary Public, State of New York
No. 52-[illegible]4478
Qualified in Suffolk County
Commission Expires March 30, 1978

EXHIBIT 1

A-541

1975

COMMODITY FUTURES TRADING COMMISSION
One World Trade Center, Suite 4747, New York, NY 10048

December 1, 1976

CERTIFIED MAIL - R.R.R.
Ms. Josephine Arcano, Vice President
Crown Colony Options, Ltd.
50 Broadway
New York, New York 10004

Dear Ms. Arcano:

A review of your firm's October 31, 1976 Statement of Financial Condition (Form 1-FR) recently submitted to our office discloses the following discrepancies:

1. The audit procedure used by our office in connection with commodity option dealers requires that the gains represented by the excess of the futures contract's market value (which underlines the option contract) over the option contracts striking price, be credited to the customer's equity account and the debit be shown as due from carrying brokers on the London Exchange, whichever is applicable. It appears from an examination of your firm's Form 1-FR that this procedure was not followed. As a consequence, the required 5 percent charge against working capital for the debit amount receivable and the required 5 percent charge for aggregate indebtedness for the amount credited were not taken.

   The audit performed on your firm's books and records as of August 31, 1976 disclosed that the unrealized gains of your customers on commodity options trading was approximately $175,000.00. Using this figure as a basis, the working capital shown on your firm's Form 1-FR would be reduced by about $35,000.00.

2. In a phone conversation with your accountant Mr. David Weinless, agreement was reached that receivables and current liabilities should be offset against each other by $128,625.00 thereby reducing charges against working capital by a significant amount. However, for your

information, we wish to bring to your attention that in order to make an entry on Schedule No. 1 item 7 for collateralized liabilities, a list must be attached to the Form 1-FR as described on the back of Schedule No. 1 in paragraph 2.

The above-mentioned matters are being brought to your attention so that, in the future, your firm can avoid making similar errors in preparing it's Form 1-FR, and also as an aid to your planning future capitalization of your firm.

Sincerely,

Marvin Jackson

Marvin Jackson, Acting Branch Chief
Office of Audit and Financial Review
Division of Trading and Markets
Eastern Region

EXHIBIT "D" TO AFFIDAVIT OF CHARLES J. HECHT

1975

## BACKGROUND ON CFTC COMMODITY OPTIONS REGULATIONS

Interim CFTC regulations for trading in the U.S. of commodity options go into effect at 12:01 a.m., Dec. 9. This is the beginning of the first phase of a two-stage regulatory process. Early in 1977, a rigidly controlled 3-year test program designed eventually to determine if and under what circumstances options should be allowed on domestic commodity markets will be instituted by CFTC.

The Commission's objective in the interim regulations is to assure options buyers receive full details of each transaction, and that options sales are conducted through registered, financially responsible persons.

The stringent regulations were adopted under authority of the Commodity Exchange Act, as amended by the Commodity Futures Trading Commission Act of 1974, and were detailed by the Commission in a Federal Register notice of November 24, 1976.

They provide:

-- All persons offering commodity options to the public must be registered with the CFTC as Futures Commission Merchants (FCM's), and their employees as Associated Persons; a lag time was allowed to permit fulfillment of registration requirements. On and after January 17, 1977, it will be unlawful for unregistered individuals to conduct commodity options transactions with public customers.

-- All Futures Commission Merchants engaged in commodity options transactions must maintain a minimum adjusted working capital of at least $50,000.

-- Options customers must be provided with a summary disclosure of the various aspects of transactions prior to purchasing the commodity option. The disclosure must contain a statement listing all fees and charges to be paid by the customer -- such charges as premiums, mark-ups on premiums and sales commissions -- as well as an explanation of the risks involved. Customers must be advised of the duration of the option being offered, the quantity and quality of the commodities which may be purchased or sold if the option is exercised. They must be informed as to how the premium is established, and how the price at which the commodities might be sold or purchased (striking price) is arrived at. There also must be a statement that the price of the commodity futures contract underlying the option contract must rise above or fall below the striking price, as the case may be, for the customer to realize a profit in the options transaction.

EXHIBIT "D"

-- An amount equal to 90% of the purchase price must be segregated by the firm accepting payment from the customer. This provides the customer with a kind of "insurance" that he will not lose his entire investment if the company should go out of business. Implementation of this segregation section of the first-stage regulations becomes effective December 27, 1976.

The limited, three-year (or shorter) test program under the second stage will require commodity options to be purchased and sold only on or thr the facilities of Commission-designated boards of trade in the United States, or Commission-recognized foreign commodities exchange systems which satisfy stringent self-regulation requirements.

The test program will be designated to determine the nature and extent of the economic impact of commodity option trading on the underlying futures and cash markets, the economic utility of such trading, and the capability of the exchanges to conduct adequate market surveillance.

# # # #

A-545

# Twelve Questions to Ask If You Get a Telephone Call Offering to Sell You a Commodity Option

1. How did you get my name?
2. What is the total price I will pay for this option?
3. What total of commissions, fees, and other charges will I pay?
4. What is today's quote for this option on the London Exchanges?
5. Where can I, regularly, get quotes from the London Exchanges on this option?
6. How much does the commodity price have to change in my favor in order for me to get all of my money back and make a profit?
7. If the market moves against me, how much of my investment do I get back?
8. Will I have to put up any additional money at any time during the life of the option?
9. How long have you and your company been selling options?
10. Is there a well-known local or national brokerage firm who knows and will recommend your company?
11. Since I don't have to make a decision until I receive your disclosure statement, when will you send the written disclosure statement to me?*
12. Are you registered, and is your company registered, with the Commodity Futures Trading Commission?

---

*NOTE: As of December 9, 1976, all purchasers of commodity options are entitled to a disclosure statement which will disclose, among other things, the amount of all commissions and fees to be paid. In addition, a written confirmation statement must be sent within 24 hours after a transaction is executed on behalf of a customer. The disclosure statement must contain the following disclaimer:

> "Because of the volatile nature of the commodities markets, the purchase of commodity options is not suitable for many members of the public. A person should not purchase a commodity option unless he is prepared to sustain a total loss of the purchase price of the commodity option. Such transactions should be entered into only by persons who are aware of the potential for loss and who understand the nature and extent of their rights and obligations.
>
> These commodity options have not been approved or disapproved by the Commodity Futures Trading Commission nor has the Commission passed upon the accuracy or adequacy of this statement. Any representation to the contrary is a violation of the Commodity Exchange Act and the regulations thereunder."

A-546

# RECENT CFTC COMMODITY OPTIONS ENFORCEMENT ACTIONS

In recent weeks, the Commodity Futures Trading Commission enforcement division has obtained consent decrees in suits which sought to enjoin two U. S. firms from violating provisions of the Commodity Exchange Act and rules of the Commission relating to sales of London commodity options. The companies involved are Rosenthal & Co. of Chicago and First Commodity Corporation of Boston.

On November 9, 1976, Rosenthal & Co. consented to a preliminary injunction in Federal court barring the firm from further violations of the Commission's antifraud rules in the sale of London options. In its consent, the firm neither admitted nor denied the allegations contained in the CFTC suit. The Commission charged Rosenthal & Col. and 15 individuals associated with that firm with cheating, defrauding, deceiving and making false reports or statements to persons in connection with the sale of commodity options. The complaint charged the defendants were engaged in an organized, nation-wide, high-pressure "boiler room" type sales campaign in offering and selling London commodity options to the public. It alleged the campaign consisted primarily of repeated, unsolicited telephone calls to persons inexperienced and unsophisticated in options transactions, and that prospective customers were given false and deceptive statements about "fantastic" profit expectations and about the "guarantee" of the option. According to the CFTC suit, Rosenthal had taken more than $34 million from options customers during 1976. Approximately $16 million was alleged to have been commissions and fees.

On November 11, 1976, First Commodity Corporation and its officials consented to a permanent injunction barring them from future violations of antifraud rules on commodity option sales. The defendants agreed to all of the injunctive relief sought by the CFTC without admitting or denying Commission allegations that London commodity options buyers had been defrauded, deceived and cheated in transactions with the firm. CFTC investigators found evidence, the complaint charged, that customers had been lured into unprofitable transactions as the result of false and misleading statements concerning risks, costs, profits, and protections for investment in the London market, that the company failed to keep proper records, failed to maintain a segregated bank account containing funds sufficient to cover all customer credits and equities, as required by law, and failed to meet Commission requirements for adjusted working capital. An estimated $3.6 million was invested, according to the CFTC complaint, by customers of First Commodity Corporation.

The Commission has also taken action aginst J. S. Love & Associates Options, Ltd., American-Overseas Trading Corporation and American Options Corporation. Many other commodity options investigative efforts are also currently underway in the CFTC's enforcement division.

A-547

NEWS

COMMODITY FUTURES
TRADING COMMISSION

2033 K STREET, N.W.
WASHINGTON, D.C.

FEDERAL REGULATORY AGENCY
FOR FUTURES TRADING

1975

Release #228-76

James E. Stiner (202) 254-8630

Ray K. Schleeter (202) 254-8630

For Release 1:30 p.m. EST, Wednesday, December 8, 1976

WASHINGTON -- A "Consumer Hot Line" (800-424-9838) and a list of twelve guideline questions designed to help consumers get useful information from telephone salesmen offering commodity options were announced today by the Commodity Futures Trading Commission.

The Commission said millions of dollars have been lost, and warned consumers to "thoroughly check out" and "shop around" if they get a phone call suggesting fantastic profits through quick options purchases.

The CFTC also pointed out that it was not saying "don't buy", but stressed the need to protect the customer and the reputable firms in the business by encouraging the proper information be obtained and impulse purchases be avoided.

The consumer alert came on the eve of the effective date for tough new CFTC regulations controlling U.S. sales of options on commodities such as sugar, coffee, cocoa, gold, silver, copper and platinum.

"Thousands of consumers -- farmers, businessmen, housewives, senior citizens -- are getting unsolicited phone calls from boiler-room sales operators," said CFTC Chairman William T. Bagley. "Fast talking pitch-men with little experience in the options business read mimeographed statements and use high pressure techniques.

(more)

They convince customers not knowledgeable in the art of commodity options trading to buy on impulse -- luring them with promises of big profits that are sometimes even said to be 'guaranteed'."

"We just want consumers to know they should be wary of these cold canvass calls. They should thoroughly check out any options sales company, and they should shop around for price. They should know what they're getting into, the risks involved, and what they stand to lose," Bagley said.

Bagley cited the example of a Kansas farmer who got a call offering a cocoa option for $4700. He called a second, established firm and found that the option was quoted in London for $2350 and could be purchased from that firm for $2700, a savings of $2000 in commissions and fees.

CFTC Vice Chairman John V Rainbolt, II, said that the CFTC interim options regulations, which go into effect at 12:01 a.m., Dec. 9, require that every options salesman make full disclosure of all commissions, fees, and other charges, and then follow up with a written confirmation.

"We're not saying don't buy commodity options, and we're not trying to put reputable options dealers out of business," Rainbolt said. "There are knowledgeable people who have made some attractive profits. But we have learned through our enforcement efforts that there are some unsavory elements operating in a heretofore unregulated business and a lot of consumers have lost millions of dollars as a result of fraud and unethical sales techniques."

"We have an obligation as a regulatory agency to protect both the consumer who would like to invest and the reputable firms who now offer commodity options. The volatile nature of the commodities markets could make them a trap for the unwary. We want to weed out the unscrupulous operators," Rainbolt said.

(more)

The CFTC's "twelve questions", which are not intended to be an end-all, are designed to help a consumer get good price information so he can make an informed judgment prior to purchase. The Commission also points out that according to the new options regulations, each customer is entitled to a written disclosure statement, including a tough disclaimer, within 24 hours of a transaction. The consumer doesn't have to, and should not, make a final decision on purchase until after he receives that statement.

The "Consumer Hot Line" will operate during Washington, D.C. business hours. It will serve to assist consumers with information about commodity option regulations and will receive complaints about suspected improper options transactions. Copies of the "twelve questions" will also be available through the phone number or by writing to the CFTC Consumer Office, 2033 K Street, N.W., Washington, D.C. 20581.

# # # #

EXHIBIT "E" TO AFFIDAVIT OF CHARLES J. HECHT

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the
COMMODITY FUTURES TRADING COMMISSION;
JOHN V. RAINBOLT III, Vice Chairman
of the COMMODITY FUTURES TRADING
COMMISSION; READ P. DUNN, GARY
SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES
TRADING COMMISSION,

Defendants.

AFFIDAVIT

76 Civ 5124 (Knapp)

JOHN FORMA, being duly sworn, deposes and says:

1. I am the president of British American Commodity Options Corp., one of the plaintiffs herein and submit this affidavit in support of the plaintiffs' request for a stay pending appeal of the regulations relating to disclosure requirements promulgated by the defendants on November 24, 1976.

2. As heretofore shown to the Court, the defendants have embarked on a massive public relations campaign to discourage prospective investors from purchasing London commodity options.

3. I have received numerous complaints from my salesmen that when prospective customers call the "wire houses", such as E.F. Hutton & Co. and Merrill Lynch, Pierce Fenner & Smith, they are advising them not to buy London commodity

options but to buy CBOE options instead. They are doing the CFTC's dirty work.

4. Notwithstanding the holidays, which did not affect our sales last December, these direct and indirect tactics have materially and adversely affected both sales and revenues as shown by the table annexed hereto.

5. Obviously, if this continues for a substantial period of time, the company will be required to close its doors. In view of the new disclosure regulations, which place us at a distinct competitive disadvantage to writers of CBOE options and purveyors of futures commodity contracts, which industry is also regulated by the defendants, it is my opinion that it will be extremely difficult, if not impossible, to compete with these other forms of investments. It is also deponent's belief that British American is the largest company in the United States which exclusively specializes in the retail of London commodity options and that the adverse impact of these punitive disclosure requirements on other members of the industry is even more severe than on my company.

6. Accordingly, the deponent respectfully requests that the Court stay the enforcement of the regulations, exclusive of the double segregation requirements set forth in Section 32.6 as to which the defendants are already enjoined, pending an appeal of the Court's order denying the relief requested with respect to disclosure, as well as the minimum financial and registration requirements of the

regulations promulgated on November 24, 1976.

____________________________________

John Forma

Sworn to before me this
________ day of December, 1976.

______________________________

Notary Public

|  | Month of November, 1976 (unaudited figures prepared by Katz, Zuckerman & Co.) |  | Month of December, 1976 (estimated as at December 28, 1976) |  |
|---|---|---|---|---|
| Gross Option Premiums |  | $ 2,238,748 |  | $ 1,000,000 |
| Cost of Options |  | 1,539,848 |  | 720,000 |
| Sub-total |  | 708,911 |  | 280,000 |
| Direct Selling Commissions |  | 235,983 |  | 29,000 |
| Gross Profit on Sales |  | 472,928 |  | 251,000 |
| Overhead Expenses: |  |  |  |  |
| Telephone | $ 126,923 |  | $ 120,000 |  |
| Rent | 6,157 |  | 6,157 |  |
| Sales, promotion and advertising and related expenses | 32,469 |  | 30,000 |  |
| Back office salaries and computer expense | 20,114 |  | 20,114 |  |
| Legal and accounting | 35,093 |  | 30,000 |  |
| Officers' salaries | 2,275 |  | 2,000 |  |
| Research, subscriptions and salaries | 11,191 |  | 11,191 |  |
| Miscellaneous | 14,104 |  | 10,000 |  |
| Total |  | $ 248,326 |  | $ 229,462 |
| Net operating income |  | 224,602 |  | 21,538 |
| Provision for federal, state and local taxes |  | 133,000 |  | 12,000 |
| Net Income |  | $ 91,602 |  | $ 9,538 |

Civil Action No. 76 Civ. 5124 (WK) (Consolidated)

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS CORP., ET AL.,
Plaintiffs,

v.

WILLIAM T. BAGLEY, ET AL.,
Defendants.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, ET AL.,
Plaintiffs,

v.

COMMODITY FUTURES TRADING COMMISSION, ET AL.,
Defendants.

76 Civ. 5124 (WK)

(Consolidated)

NOTICE OF MOTION

TO: CHARLES J. HECHT, ESQ.
Attorney for Plaintiffs
60 East 42nd Street, Suite 1760
New York, New York 10017

LEONARD R. GOLDSTEIN, ESQ.
Attorney for Plaintiffs
Goldstein, Ahalt & Bennett
4321 Hartwick Road, Suite 300
College Park, Maryland 20740

PLEASE TAKE NOTICE that, upon the Memorandum in support hereof, and all pleadings and papers previously filed and proceedings heretofore had in the above-captioned action, defendants will move before the Honorable Whitman Knapp, United States District Judge, in Room 307 of the United States Courthouse, Foley Square, New York, New York, on the 12th day of January, 1977, at 4:30 p.m. that day, or as soon thereafter as counsel can be heard, for reconsideration of the Court's Order of January 4, 1977, insofar as it denied defendants' motion for summary judgment regarding the validity of the segregation requirements contained in Section 32.6 of regulations published in the Federal Register on November 24, 1976 (41 Fed. Reg. 51808), and preliminarily enjoined defendants, during the pendency of the action, from enforcing the segregation provision against any plaintiff who is in the business of selling commodity options as an agent for a principal.

Frederic T. Spindel
FREDERIC T. SPINDEL
Associate General Counsel

Commodity Futures Trading
  Commission
2033 "K" Street, N.W.
Washington, D.C.   20581

January 10, 1977

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP., ET AL.,

Plaintiffs,

v.

WILLIAM T. BAGLEY, ET AL.,

Defendants.

NATIONAL ASSOCIATION OF COMMODITY OPTION
DEALERS, ET AL.,

Plaintiffs,

v.

COMMODITY FUTURES TRADING COMMISSION, ET AL.,

Defendants.

Civil Action No.

76 Civ. 5124 (WK)

(Consolidated)

## MEMORANDUM IN SUPPORT OF DEFENDANTS' MOTION FOR RECONSIDERATION

By Order of January 4, 1977, this Court, *inter alia*, preliminarily enjoined the Commodity Futures Trading Commission,1/ during the pendency of this action, from enforcing the segregation requirements contained in Section 32.6 of commodity option regulations adopted by the Commission, 41 Fed. Reg. 51808 (November 24, 1976), against any plaintiff who is in the business of selling commodity options as an agent for a principal,

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1/ Unless the context otherwise requires, the Commodity Futures Trading Commission and its five individual members named as defendants in these consolidated actions shall hereinafter be referred to collectively as "the Commission."

and to that extent denied the Commission's motion for summary judgment.[2/]

In its Memorandum Opinion of December 21, 1976, the Court found that the Commission did not appear adequately to have justified the requirement of Section 32.6 that an option dealer segregate 90% of the funds received from customers for the purchase of options, particularly in view of the adverse financial burden which the Court found such requirement would impose upon option dealers who act as "agents for London principals" and who, like plaintiffs, are required to transfer to London a significant portion of the purchase price received from their customers (Op. 3, 13-14). On this basis, the Court concluded (Op. 14)

> "that plaintiffs have a reasonable likelihood of success in establishing that defendants acted arbitrarily and capriciously in imposing segregation requirements--at least as applicable to option dealers, who, like plaintiffs, act only as agents. . . ."

The Court further ruled (Op. 15) that plaintiffs

> "are threatened with irreparable injury in that, being required . . . to forward to their principals in London the premiums for options they sell to their customers (representing at least 75% of the funds received from customers), they could not long remain in business if required to segregate in the United States an amount equal to 90% of such funds. . . ."

This Memorandum is submitted in support of the Commission's motion for reconsideration of that decision.

---

[2/] The Commission had adopted its option regulations pursuant to Sections 2(a)(1), 4c(a) 4c(b) and 8a of the Commodity Exchange Act, as amended, 7 U.S.C. §§2, 6c(a), 6c(b) and 12a. In these actions plaintiffs have attacked various provisions contained in the regulations. As to all issues in the case, other than those involving the segregation provisions of Section 32.6, the Commission's motion for summary judgment was granted.

## ARGUMENT

1. The Court's opinion reflects a fundamental misunderstanding of the nature of plaintiffs' business activities as shown by the record. There is no evidence in the record to support the Court's pervasive assumption (Op. 2, 3, 4n.7, 9n.20, 10, 11, 12n.27, 13, 14, 15, 19-20), that option dealers, such as plaintiffs, sell options as agents for principals in London or elsewhere. Rather, it appears to be undisputed in the record before this Court that plaintiffs buy options for the account of their customers and, accordingly, act solely as their customers' agents. This relationship is clearly established in the description of plaintiffs' business operations presented by plaintiffs British American and Lloyd, Carr in the December 9, 1976, memorandum filed in support of their motion for preliminary injunction.

In their papers, plaintiff British American avers that after it obtains an order and receives funds from an option customer it will transmit the order to a "clearing agent" or "clearing broker" of the London exchange, which, in turn, will purchase the option on the London market from the option writer or "grantor" and then record the purchase on its books for British American's account.[3] Thus, the clearing member with which British American deals acquires options for British American, through the exchange, solely in response to orders placed with it by British American; in turn, British American is acting as agent for its customers when it places those orders.[4/]

---

[3] See Memorandum in Support of Plaintiffs' Motion for a Declaratory Judgment and Preliminary Injunction, etc. dated December 9, 1976, pp. 2-8 (hereinafter "P. MEM. p. ___"). The description contained in the Memorandum has been verified by an affidavit submitted by John Forma, British American's president. Affidavit of John Forma dated December 9, 1976, para. 3.

The Court's assumption that plaintiffs act as agents for London principals is not only inconsistent with this description by plaintiffs of their own business activities but is at variance with usual business practices concerning commodity options as set forth in the report presented to the Commission by its Advisory Committee on the Definition and Regulation of Market Instruments, which previously has been submitted to this Court. On the basis of discussions with representatives of the Bank of England, the London exchanges, and clearing members, the report stated that principal-to-principal relationships generally existed on the London exchanges and through the chain of transactions between the writer of an option in London and the firm which purchases the option for its customer in the United States. Advisory Committee Report pp. 135-136, 139.[5/]

Since it appears that none of the plaintiffs sell commodity options as agents for a principal, the Court's order would not relieve these plaintiffs from the duty to comply with the Commission's segregation regulation. However, before taking such a position and enforcing

---

[4/] Plaintiffs' Memorandum indicates that Lloyd Carr & Co. follows a similar procedure, acting for the accounts of its customers solely in response to specific purchase orders. See P. MEM. pp. 2-7.

[5/] See also, in particular, comment letters received by the Commission from the London Commodity Exchange, which emphasized the principal to principal relationship that exists between the option writer and the purchaser of the option through the exchange involved in these transactions. These comment letters also tend to show that the option dealer in the United States does not act as a sales agent for the writer in London, as the Court assumed (Op. 2, 3, 4n.7, 9n.20, 10, 11, 12n.27, 13, 14, 15, 19-20), but acts only as agent for his customer. These letters, which have already been submitted as part of the record, are attached hereto as Exhibits A and B.

the segregation requirement against plaintiffs who may be shown to act as agents for their customers, the Commission respectively requests this Court to clarify the basis for its assumption that option dealers sell options for principals in London and the intent of its Order (if that order should not be vacated, as we suggest, for the reasons discussed in this Memorandum).[6/]

2. The Court also erred in its basic premise that dealers in futures contracts, for whom a segregation requirement exists under the express provisions of the Commodity Exchange Act,[7/] "normally act as principals" and are thus distinguishable from commodity "option dealers who, like plaintiffs act only as agents" (Op. 13). Contrary to the Court's unsupported supposition, futures commission merchants do not act as principals, but act solely as agents, when acquiring futures positions for the accounts of their customers. Indeed, it is unlawful for a futures commission merchant to offer a futures contract it has acquired for its own account to any person; a futures contract may lawfully be acquired for the account of a customer only through the facility of the exchange.[8/]

---

[6/] The Court may have felt that in acting as agent for a London principal, the funds transferred to such London principal may somehow have been available for the benefit of United States option customers. But, as we show on page 11, infra, such funds as are transferred to London are specifically held for the benefit of the grantor of the option and not for the benefit of the United States customer. Moreover, as we have shown in this section, there is no principal-agent relationship between the grantor of the option in London and the option dealer purchasing the same for a United States customer.

[7/] As the Court is aware, pursuant to Section 4d(2) of the Commodity Exchange Act, 7 U.S.C. §6d(2) (Supp. V, 1975), a futures commission merchant must segregate the funds of its futures customers.

[8/] Section 4h, 7 U.S.C. §6h (1970).

Since option dealers similarly act as agents for their customers—although many must act through intermediaries to obtain access to the London exchanges—the Court's analogy to futures activities tends to support the reasonableness of the Commission's imposition of a segregation requirement upon option dealers; it does not, as the Court erroneously seems to have assumed, involve a meaningful distinction that the Commission was required to explain.

3. In its opinion, the Court seems to have overlooked the Commission's express statement of the purposes to be served by segregation, and thus did not fully consider the basis upon which the reasonableness of the segregation requirement may properly be evaulated. The segregation requirement contained in Section 32.6 is designed to assure that, if an option firm becomes insolvent during the term of the option, its customers will at least be able to obtain return of nearly all of their original investment. As the Commission explained in its October 8, 1976 Federal Register notice proposing the segregation provision:

> ". . . in the Commission's view, what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase the option will be safe during the term of the option and be available to be refunded to option customers in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligations owing to him because of the insolvency of the futures commission merchant . . . ." 41 Fed. Reg. 44564.

The Commission further emphasized that by segregating assets in the United States "such assets will not be subject to the attachment or other laws or requirements of any other nation," id. at 44564, and that segregation will "help to prevent fraud" since, "[a]bsent segregation, these assets could be used by a person in its general operations . . . ." Id. In this regard, the rule is not significantly different in purpose than the requirements of Section 4d(2), supra, n. 7, which was and is designed to protect the customers of futures commission merchants from similar contingencies with respect to their futures trading activities.[9] In fact, the history of fraudulent practices and insolvencies by commodity option firms, and the resulting losses to public investors, indicated a particular need for the protections afforded by segregation.[10]

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[9] As stated by Senator Murray in the congressional debates on H.R. 6772, 74th Cong., 1st Sess. (1935) leading to the adoption of Section 4d(2) in 1936 as part of the original Commodity Exchange Act:

> "This section merely provides that the public's money put up for margins shall be in fact treated as belonging to the customer, and held in trust . . . .
>
> The recent failure of a large commission firm in Chicago finds that the public is holding the sack for almost a million dollars in margin moneys." 80 Cong. Rec. 7858 (daily ed. May 25, 1936) (emphasis added).

Also, as stated by Senator Norris:

> "The only purpose of the amendment is to protect money that is really a trust fund, sent to a commission agent and kept on deposit with him; to protect the margins of the customer and to prevent illegal use of the money for some other purpose." 80 Cong. Rec. 7911 (daily ed. May 26, 1936) (emphasis added).

The legislative history of the Commodity Futures Trading Commission Act of 1974 also recognizes the purpose of the segregation requirements of section 4d(2). As was noted in the House Report:

> "Brokerage firms hold large sums of money representing customers' margins. The use of such funds to finance the firms' own operations or the operations of favored customers could result in financial losses by other customers."

H. R. Rep. No. 93-975, 93d Cong., 2d Sess. 68 (1974).

Section 32.6 was thus designed to require prompt segregation in the United States of 90% of the funds received from the customer. These funds are to be treated as the property of the customer until the option has expired or has been exercised and all proceeds due the customer have been paid. As a result, in the event of the firm's insolvency the customer will at least be able to obtain return of most of the funds he advanced. Of course, it may be possible for the customer of an insolvent option dealer to trace his property interest in specific commodity options purchased for his account through the bankrupt's estate and consequently obtain a greater return than the minimum assured through segregation. However, that prospect is by no means certain. See, *e.g.*, *In the Matter of J. S. Love & Associates Options, Ltd., Bankrupt*, Bankruptcy No. 76 B 590 (S.D.N.Y., May 20, 1976). It was this uncertainty, in fact, which led the Commission to adopt the segregation requirement.

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[10] The legislative history of this Act shows that Congress was concerned about the financial failure of firms' dealing in commodity options. See, e.g., H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 38, 37 (1974); see also Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., Ser. 93-TT at 181-182, 194-196 (1974); Hearings on S. 2485, S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess. pt. 1, at 224-225, pt. 3, at 682-683, 830-835 (1974) (testimony of Tom Maher and Glenn Willet Clark, and statement prepared by James Ryan and Richard Malm). See also, Securities and Exchange Commission v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Securities and Exchange Commission v. Univest, Inc., 405 F.Supp. 1057 (N.D. Ill. 1975), appeal pending, Civ. No. 76-1734 (7th Cir. 1976); Securities and Exchange Commission v. Norton, CCH Comm. Fut. L. Rep. para. 20, 204 (N.D. Ill. 1976); Securities and Exchange Commission v. Williams, No. 76-1064 (10th Cir., Dec. 13, 1976); Glazer v. National Commodity Research & Statistical Service, Inc., 388 F.Supp. 1341 (N.D. Ill. 1974); In re Traders International, Ltd., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. para. 94, 529 (D. Nev. 1974); Securities and Exchange Commission v. Goldstein, Samuelson, Inc., Civil No. 73-472 (C.D. Cal. Oct 29, 1973)(Orders of permanent injunction by consent, under federal securities laws).

In addition, the Commission since coming into existence has itself instituted a number of enforcement actions involving fraudulent practices by commodity option dealers. See Commodity Futures Trading Commission v. First Commodity Corp. of Boston, Case No. 76-4051 M (D. Mass. 1976)(permanent injunction entered November 11, 1976); Commodity Futures Trading Commission v. Rosenthal & Co., Civil Action No. 76 C 3904 (N.D. Ill., 1976) (consent to preliminary injunction entered November 8, 1976); Commodity Futures Trading Commission v. American Options Corp., No. 75-3355 (C.D. Calif. 1975); Commodity Futures Trading Commission v. J. S. Love & Associates Options, Ltd., Civil Action No. 76-928 (DBB) (S.D. N.Y. 1976)(consent injunctions entered on March 1, 1976); Commodity Futures Trading Commission v. American Overseas Trading Corp., C-75-1970A (N.D. Ga. 1976)(permanent injunction entered October 15, 1976).

Absent the segregation requirement imposed under Section 32.6, no provision of domestic or foreign law, and no usage in the commodity option trade either here or in London, directly insures the funds of a customer in the United States against insolvency or wrongful acts by any of the persons who may become involved in the option transaction. This is clearly established in the record of the rulemaking proceeding, which is before this Court. Thus, the Court erred in believing (Op. 14) that the record does not disclose facts to support the Commission's decision to impose a segregation requirement.

Specifically, after a seven-month study, the Advisory Committee, in recommending that the Commission provide for segregation of customer funds, reported in July 1976 that funds received from option customers in the United States were not segregated for the customers' benefit either by option dealers in the United States or by the London exchanges or their members, and that neither the International Commodity Clearing House ("ICCH") nor the London Metals Exchange ("LME") provide a guarantee of the performance of obligations concerning London options which extended to the United States customer.[11/] The Advisory Committee's statement followed testimony at the Commission's March 8, 1976, oral hearing at which plaintiffs' own counsel conceded that the London guarantees do not run to option customers in the United States.[12/] It also followed the Commission's receipt of public comments on the rules it had proposed

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[11/] The Advisory Committee stated:

> "At the present time, neither United States nor London vendors of . . . [options cleared by the International Commodity Clearing House or vended through members of the London Metals Exchange] are required to segregate funds received from United States customers. Moreover, neither the ICCH nor the LME currently guarantees to United States customers the performance of obligations on any ICCH or LME option. The Advisory Committee has been informed that these and other circumstances, such as the absence of financial requirements for option dealers in the United States and the lack of regulation of the United States market for Foreign Options, make it very difficult for United States customers to obtain redress in the United States from dealers of 'London' options in the event of a default on the option transaction. On this basis, the Advisory Committee has determined that, to the extent possible, these deficiencies should be remedied by the Commission."

Advisory Committee Report at pp. 41-42 (emphasis added). The Commission specifically referred to this statement when announcing the adoption of the option rules. 41 Fed. Reg. 51812 (November 24, 1976).

[12/] See Transcript of March 8, 1976 hearing, pp. 148-56 (Testimony of Charles Hecht, Esq.) at Tab 4 of Record of Rulemaking Proceeding.

on February 20, 1976, which urged the imposition of some form of segregation.[13]

The absence of any meaningful customer protection was also confirmed by comment letters submitted to the Commission by the London Commodity Exchange (Exhibits A and B hereto), which make clear that existing guarantees run only to clearing members of the London exchanges, in whose names the option contracts are registered, and that the guarantee could not be extended to customers of an option dealer in the United States unless and until exchange rules are amended to permit dealers who become clearing members of the London exchange to establish special segregated depository accounts for United States customers. Exhibit A, p. 1; Exhibit B, p. 5. The London Commodity Exchange comment letters further explained that at present option premiums transmitted to London from option dealers in the United States are segregated--but not for the customer's benefit. They are placed in a "special grantor's premium account" to be paid to the London option writer upon his fulfillment of the option or, in the event of the writer's inability to perform, to be drawn upon by the ICCH for use in guaranteeing performance to the clearing member. There is no contingency upon which those funds would or could be returned to the customer in the United States. See Exhibit A, p. 3,4; Exhibit B, p. 3.

During the period the Commission was considering option regulations, the Commission was confronted with facts evidencing a continuing pattern of fraudulent and other improper practices by London option dealers[14] and the bankruptcy of J.S. Love Associates, which appeared likely to result in substantial losses to investors who had purchased London options through that firm. Since April 1975, the Commission's considerable enforcement "experience" in the options area, to which the Commission specifically adverted in announcing the adoption of the interim rules on November 24, 1976, containing the segregation requirement (41 *Fed. Reg.* at 51809), thus afforded additional factual support for the Commission's determination regarding segregation. See *e.g.*, *Consumer's Union of United States* v. *Consumer Products Safety Commission*, 491 F.2d 810 (2d Cir. 1974).

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[13] See Letter from New York Cocoa Exchange dated March 5, 1976; Letter from MacDonald, Kriger & Bowyer, Inc., dated March 31, 1976 at Tab 3 of Record of Rulemaking Proceeding.

4. Section 32.6 would generally require an options firm to advance its own (or borrowed) funds for the account of its customer in order to acquire the option and to cover its operating expenses until the option is exercised or lapses. Implicit in this requirement is an administrative judgment made by the Commission that, in view of the recurring abuses which have attended options transactions in this country, only those firms which are financially capable of implementing the protections of segregation should be allowed to solicit and to obtain funds from the public.

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[14] *See*, *e.g.*, *Commodity Futures Trading Commission* v. *First Commodity Corp. of Boston*, Case No. 76-4051 M (D. Mass. 1976)(permanent injunction entered November 11, 1976); *Commodity Futures Trading Commission* v. *Rosenthal & Co.*, Civil Action No. 76 C 3904 (N.D. Ill. 1976) (consent to preliminary injunction entered November 8, 1976); *Commodity Futures Trading Commission* v. *American Options Corp.*, No. 75-3355 (C.D. Calif. 1975); *Commodity Futures Trading Commission* v. *J. S. Love & Associates Options, Ltd.*, Civil Action No. 76-928 (DBB)(S.D. N.Y. 1976) (consent decrees entered March 1, 1976); *Commodity Futures Trading Commission* v. *American Overseas Trading Corp.*, C-75-1970A (N.D. Ga. 1976) (permanent injunction entered October 15, 1976).

Although the Court appears to have found (Op. 15) that the burden imposed by the segregation requirement provides so great a hardship that option firms "could not long remain in business if required to segregate in the United States an amount equal to 90% of . . . [the] funds advanced by customers," plaintiffs themselves have not seriously advanced so extreme a contention. Instead, plaintiffs have argued merely that so-called smaller firms will not survive, and they have tried to suggest that the field will unfairly be left only to larger firms "who are very willing to finance segregation." (P. Mem. p. 22; *see also* Affidavits of Peter E. Aaron dated December 2, 1976, pp. 3-4, 15, and John Forma dated December 9, 1976, p. 2). Thus, plaintiffs implicitly admit that the burden imposed by Section 32.6 is not incapable of being met--they recognize that firms can and will survive, and can and will meet the segregation requirements in doing so. On the other hand, firms, small or large, which are inadequately capitalized in relation to the volume of option transactions being conducted may not be in a financial position to meet these requirements at present.[15/]

But the fact that a regulatory standard cannot be met by certain members of an affected industry does not demonstrate that the regulation is arbitrary or capricious. See *Bowles* v. *Willingham*, 321 U.S. 503 (1943); *Mulford* v. *Smith*, 307 U.S. 38 (1939). Where, as here, the

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[15/] Although, as the Court observed (Op. 17), plaintiffs have contended that the segregation requirements will unduly deplete their assets and thus prevent them from meeting the minimum financial requirement of the regulations, segregation of funds by the dealer does not in any way affect the computation of net capital required under Regulation 1.17 for such dealers. In computing net capital, the option dealer may include as a current asset customer funds which it places in segregation.

requirements are clearly effective in achieving the purpose to protect customers, the fact that some firms may be unable to comply is a reason why the rule is sound, not a reason why it may or should be rejected.

In an analogous situation, this Court upheld the propriety of a regulatory scheme that imposed a harsher restriction on small collateral lenders who financed securities purchased on margin than were imposed on presumably larger banks and broker-dealers. Collateral Lenders Committee v. Federal Reserve System, 281 F. Supp. 899, 911-12 (S.D.N.Y. 1968). In that context, this Court stated:

> "The defendant does admit, and the Court recognizes, that there will be a significant impact on the plaintiffs' business; indeed, that is the purpose of the regulation and it is undoubtedly true that compliance with Regulation G will require plaintiffs to readjust and reorganize their methods of doing business."

But, rather than conclude that Regulation G was invalid because certain members of the affected industry would suffer irreparable injury from its requirements, the Court emphasized the risk that the public would suffer irreparable injury in light of the threat to the investing public and the economy as a whole if the requirement were not sustained. See also Crimmins v. American Stock Exchange, Inc., 368 F. Supp. 270, 280 (S.D.N.Y. 1973). It is respectfully submitted that a similar customer protection standard is of paramount importance in the instant case and that similar deference should be given to the administrative determination made by the Commission.

Moreover, while the Court in the instant case apparently found it unreasonable that the Commission might compel an option dealer to advance its own funds to pay the premium on an option it acquires for its customer's account, there is nothing remarkable about an agent advancing funds for the account of its principal. In fact, it is an everyday occurrence that securities brokers advance their own or borrowed funds to buy securities for margin account customers who, under Federal Reserve Board regulations, are permitted to pay only a certain percentage of the purchase price for securities, and who, under securities options regulations recently adopted, will be permitted to pay no amount at all.[16/]

To be sure, there are differences between purchases of securities on margin (voluntary on the part of the broker-dealer) and the acquisition of commodity options subject to a segregation requirement (mandatory). What is essentially the same, however, is that each advances funds for the benefit of the customer, and we are aware of no basis upon which it may be claimed that securities brokers have suffered financially to the extent that they have advanced funds for their customers' accounts.

Additionally, a broker-dealer may charge his customer interest for the funds advanced for the customer's account; the option dealer will be entitled, under Section 32.6, to retain the interest earned on segregated funds and may charge his customer for any excess of expenses over income that may be incurred in this process. Broker-dealers may also hypothecate their interest in securities held on margin for the account of their customers. Presumably, an options dealer can assign as collateral,

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[16/] The extension of credit by brokers, dealers and members of the national securities exchanges is governed by Federal Reserve Board Regulation T. 12 C.F.R. Part 220 (1976). This regulation currently permits securities brokers to loan customers up to 50% of a security's current market value for the purpose of purchasing stock; 70% of the underlying market value of the security for purchasing an uncovered stock option; and 100% of the amount required to buy a covered stock option. See CCH Fed. Sec. L. Rep. ¶80,726 (1976) (publishing amendment to Regulation T adopted September 22, 1976, effective January 1, 1977).

subject to customers' interests, its own contingent remainder interest in the segregated funds to which it will be entitled when the option expires or is exercised and the proceeds are sent to the customer.

6. In ruling that the Commission appeared to have acted with undue haste when it imposed a segregation requirement, the Court seems to have relied upon an erroneous belief that it was not until October 1976 that "the Commission . . . for the first time proposed . . . segregation" (Op. 13) and that the Commission had earlier decided that segregation might well be inappropriate for some dealers (Op. 9). In support of this view, the Court asserted, among other things, that "the concept of segregation was not specifically mentioned" in the Commission's October 1975 release soliciting public comment on several possible regulatory alternatives concerning commodity options (Op. 8).

To the contrary, however, the Commission's October 22, 1975, release specifically raised the possibility of a segregation requirement in connection with the very kind of regulatory approach that is embodied in the rules adopted by the Commission in November 1976, which are at issue in the instant case. Thus, in its October 1975 release, the Commission discussed the possibility of a regulatory scheme which would involve the registration of option dealers as futures commission merchants—thereby limiting options trading to persons who meet basic fiduciary and other standards established by Congress. The Commission emphasized that to implement that approach "extensive study would be required to determine whether to adopt or amend Commission rules concerning segregation of customer funds, hedging of options and other customer protection standards" to supplement the statutory pattern of regulation, which had been designed to protect futures customers, in order to meet the unique regulatory problems that would be presented by commodity option activities. 40 Fed. Reg. 49361 (October 22, 1975)(emphasis added).

In holding that the Commission appeared to have acted too hastily, the Court also apparently found significance in the fact that the rules proposed by the Commission on February 20, 1976, had contained no segregation provision (Op. 9, 14). The Court appears erroneously to have believed (Op. 11) that the regulations subsequently proposed in October 1976 and adopted in November 1976 were merely modifications of the proposals that had been made in February. But, in sharp contrast to the rules finally adopted by the Commission--which, after January 17, 1977, will not permit a firm which writes options also to accept funds from the public[17]--the regulatory approach embodied in the February 1976 rules would have permitted an option dealer to both write *and* sell options to its customers. Under the February proposal, in order to provide appropriate investor protection, option dealers would have been required to register as such with the Commission, file disclosure statements and meet stringent minimum financial requirements.[18] Under the minimum net capital requirements proposed in February, an option dealer would have been permitted to include in its computation only those of its assets maintained in the United States (thereby excluding premium payments to London) and would have been required to mark open option positions to the market on a daily basis, and include unrealized gains due to customers on open positions in its computation. Consequently, under the rules then proposed, all option dealers would have been required to have had sufficient assets in the United States not only to cover the initial investment of customers--which is required under the segregation provisions of Section 32.6, as adopted--but also to fulfill the obligations under the commodity options themselves.

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[17] Section 32.3, 41 Fed. Reg. 51814 (November 24, 1976), requires that any firm which accepts money or property from a customer in connection with an option transaction register as a futures commission merchant. Under Commission regulation 1.19, 17 C.F.R. §1.19 (1976), futures commission merchants are precluded from writing or otherwise assuming financial responsibility for the fulfillment of options.

[18] See proposed Sections 32.2, 32.5, 41 Fed. Reg. 7780-81 (February 20, 1976). The proposed rules did not require firms to register as futures commission merchants; futures commission merchants would have been permitted to write options by virtue of the repeal of §1.19, which was also being proposed at that time. 41 Fed. Reg. 7780.

It was in the context of that regulatory proposal that the Commission expressed a willingness to entertain exemptions from the net capital requirement for those option dealers who acted as agents for other dealers who wrote options--yet another facet of the February 1976 proposals that the Court appears to have found significant (Op. 9). The Commission's willingness to consider an exemption under those proposed rules, however, merely reflected the Commission's recognition that it was not necessary to impose stringent financial requirements on firms that acted solely as agents (and which, accordingly, would not be financially responsible for performance of the option) so long as the option writer maintained sufficient assets in the United States to fulfill its obligations under the option contract. Thus, to have obtained an exemption, the agent-dealers would have had to submit proof to the Commission that

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19/ Proposed Section 32.0, 41 Fed. Reg. 7783-84 (February 20, 1976).

20/ Proposed Section 32.3, 41 Fed. Reg. 7780 (February 20, 1976).

the option writer was registered with the Commission and had sufficient assets in the United States to meet the net capital requirement. Since the writer of a London option does not normally maintain assets in the United States, however, under the February proposals option dealers offering London options in the United States would generally have been unable to obtain an exemption from the proposed net capital requirement.[21/]

In view of the protection otherwise afforded to customers under the February 1976 proposals, it was not, in the Commission's judgment, considered necessary also to require segregation of customer funds. It does not follow from this, however, as the Court seems to have assumed (Op. 9, 14), that a general segregation requirement is or was considered to be an unacceptable approach to investor protection under a different regulatory scheme--such as the one finally adopted.[22/] Moreover, it is significant that the February 20, 1976, proposed regulations were just that--proposed. The Commission, after analysis and in the exercise of its statutory responsibilities, adopted a different, but no less comprehensive, regulatory scheme.

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[21/] 41 Fed. Reg. 7776 (February 20, 1976).

[22/] Even with respect to the February 1976 proposals, the Commission did not find that segregation would be inappropriate for some option dealers, as the Court seems to believe (Op. 9). The Commission merely noted that it had decided not to impose segregation as part of the February proposals because of "difficulties involved in ascertaining which dealers should have been required to segregate" in light of other provisions then being considered. Nevertheless, as the Court recognized in its opinion, the Commission requested specific comment on whether segregation should be imposed. 41 Fed. Reg. 7776 (February 20, 1976).

7. The law requires that an administrative agency's regulations must have an adequate basis in law and fact and that they be reasonably related to the regulatory objectives properly to be served. If it may be found that the agency took a reasonable approach--albeit not necessarily the approach that a reviewing court might have chosen--the regulation must be sustained. See, e.g., General Transportation Co. of Southwest v. United States, 449 F.2d 846, 862 (5th Cir. 1971); Automotive Parts & Accessories Assn. v. Boyd, 407 F.2d 330, 343 (D.C. Cir. 1968), cited with aproval, National Nutritional Foods Assn. v. Weinberger, 512 F.2d 688 (2d Cir. 1975).

Since protection of option investors is unquestionably a Congressional objective to be implemented by the Commission under the Act, and since, as we have shown, the segregation requirement is reasonably designed to provide investor protection, adoption of the segregation provision satisfies the requisite standard for agency action. There is no further requirement that the Commission, having found a satisfactory means to meet its regulatory objectives, must divert its limited resources to a continuing search for other alternatives. Cf. Bunny Bear, Inc. v. Peterson, 473 F.2d 1002, 1007 (1st Cir. 1973); Angel v. Butz, 487 F.2d 260, 263 (10th Cir. 1973). Because the responsibility to choose among regulatory alternatives has been entrusted by law to the Commission, the Commission was at most required to explain why it did not choose to accept suggestions the commentators had advanced. See, e.g., Automotive Parts & Accessories Assn. v. Boyd, 407 F.2d 330, 338 (D.C. Cir. 1968); National Nutritional Foods Ass'n. v. Weinberger, 512 F.2d 688 (2d Cir. 1975). See also Alabama Association of Insurance Agents v. Board of Governors of Federal Reserve System, 533 F.2d 224, 236-37 (5th Cir.

1976); Public Service Com'n. v. Federal Power Com'n, 467 F.2d 361 (D.C. Cir. 1972). Florida Sugar Cane League, Inc. v. Usery, 531 F.2d 299 (5th Cir. 1976). This the Commission has done. See 41 Fed. Reg. 51812.[23/] There is no basis in law upon which it may be compelled to do more.

Under these circumstances the Commission made a permissible regulatory judgment that segregation was an effective approach to provide protection for the public; it was inappropriate for this Court to substitute its view that, because of the possible adverse effect on some persons, the public should be denied protection during an indefinite period while other alternatives were explored. Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971); Automotive Parts & Accessories Association, Inc. v. Boyd, 407 F.2d 330, 343 (D.C. Cir. 1968); First National Bank of Fayetteville v. Smith, 508 F.2d 1371,

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[23/] A number of alternatives to segregation were proposed, such as insurance, letters of credit, bonding and other forms of financial guarantees. The primary reason why none of the proposed alternatives was adopted in lieu of segregation was that "specific proposed alternatives had not yet been submitted," and it was not readily apparent that the proposals suggested were susceptible of implementation. (41 Fed. Reg. 51812 (November 24, 1976). Thus, for example, such proposals as bonding or protection through letters of credit could be evaluated only on a case-by-case basis, since the availability of protection in that form would necessarily vary from firm to firm.

Through the adoption of Section 32.4(b) of its option rules, the Commission has indicated its willingness to grant exemptions from the segregation requirements on a case-by-case basis when a firm could show that it could implement any of the alternatives urged by the commentators--or any alternative not previously proposed--in a manner that would provide a substitute for segregation which would be adequate to provide the regulatory protections that segregation affords. 41 Fed. Reg. 51812 (November 24, 1976).

1376 (8th Cir. 1974), cert. denied, 421 U.S. 930 (1975).[24/]

8. The Court, in any event, was not entitled to issue a preliminary injunction against enforcement of the segregation requirement on the basis of the record before it. A preliminary injunction is an extraordinary and drastic remedy and may be granted only upon a clear showing that plaintiffs will suffer irreparable injury if the injunction is not granted, that they are likely to prevail on the merits, and that their injury clearly outweighs any foreseeable injury to the public interest from granting the injunction.[25/] The burden of proof rests on the moving party and that burden is necessarily substantial. Robert W. Stark, Jr., Inc. v. New York Stock Exchange, Inc., 466 F.2d 743, 744 (2d Cir. 1972); Sierra Club v. Hickel, 433 F.2d 24, 33 (9th Cir. 1970, aff'd on other grounds, 405 U.S. 727 (1972); Berrigan v. Norton, 451 F.2d 790, 793 (2d Cir. 1971); Crowther v. Seaborg, 415 F.2d 437, 439 (10th Cir. 1969); Garlock, Inc. v. United Seal Incorporated, 404 F.2d 256, 257 (6th Cir. 1968); American Basketball Association v. National Basketball Association, 404 F. Supp. 832 (S.D.N.Y. 1975); Kontes Glass Company v. Lab Glass, Inc.,

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[24/] See also, Wong Wing Hang v. Immigration and Naturalization Service, 360 F.2d 715, 718 (2d Cir. 1966); In Re Josephson, 218 F.2d 174, 182 (1st Cir. 1954), both cited with approval in Citizens to Preserve Overton Park, Inc. v. Volpe, supra at 416. Accord, Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc., 419 U.S. 281, 284 (1974); Nader v. Sawhill, 514 F.2d 1064, 1067 (Tem. Emer. Cir. 1975); Environmental Defense Fund, Inc. v. Corps of Engineers of the United States Army, 470 F.2d 289, 300 (8th Cir. 1972); Rockbridge v. Lincoln, 449 F.2d 567, 572 (9th Cir. 1971).

[25/] Burns v. Paddock, 503 F.2d 18, 28 (7th Cir., 1974); Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Company, Inc., 476 F.2d 687 (2d Cir. 1973); Clairol, Inc. v. Gillette Co., 389 F.2d 264, 265 (2d Cir. 1968); Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d 921 (D.C. Cir., 1958). See generally, Wright & Miller, 11 Federal Practice and Procedure §2948; 7 Moore's Federal Practice para. 65.04.

250 F.Supp. 193, 195 (D.C. N.J. 1966), aff'd, 373 F.2d 219 (3rd Cir. 1967).

Notwithstanding plaintiff's heavy burden, however, the affidavits and other materials submitted in support of plaintiffs' motion contain little or no probative evidence in support of alleged irreparable injury or to show that the Commission's segregation provision is arbitrary or capricious. They are, instead, replete with conclusory assertions and hearsay statements. For example, plaintiffs' purported "evidence" that the segregation requirement will result in their being unable to continue in business consists almost exclusively of wholly unsupported claims that the regulations are "totally unsuitable to the industry";[26/] that "survival will be impossible";[27/] and that plaintiffs will be forced out of business."[28/]

Although several of plaintiffs' officials have offered analyses based on hypothetical financial information in an attempt to show the effect of the segregation requirement, plaintiffs have not tendered certified financial statements or even unaudited, but verified, financial statements reflecting their actual business activities, and have not explained why they have been unable or unwilling to do so. Nor have such financial statements as have been submitted accurately reflected the Commission's interpretation of Section 1.17. The record is also devoid of any evidence of efforts the plaintiffs may have made to obtain capital or arrangement debt financing to meet the segregation requirements and

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[26/] Affidavit of John Forma dated December 15, 1976, para. 9.

[27/] Affidavit of John Forma dated November 15, 1976, para. 5.

[28/] Affidavit of Charles J. Hecht dated December 3, 1976, para 11.

whether such attempts were unavailing and why. In these circumstances there was no basis upon which the Court could properly assume any plaintiff would suffer any significant adverse effect from the segregation requirements, much less that they could not long remain in business (Op. 15).[29]

Speculation as to whether irreparable injury will result--which is all the record at bar contains--is not a permissible basis upon which administrative action may be enjoined. *Hannah* v. *Larche*, 363 U.S. 420, 443 (1960). *See also* *Udall* v. *D.C. Transit System, Inc.*, 404 F.2d 1358 (D.C. Cir. 1968); *A.O. Smith Corp.* v. *Federal Trade Commission*, 530 F.2d 515 (3d Cir. 1976). As this Court observed in *Hershey Creamery Co.* v. *Hershey Chocolate Corp.*, 269 F. Supp. 45, 59 (S.D.N.Y. 1967):

> "'The issuance of an injunction is not justified by the mere fact that irreparable harm may possibly ensue if restraint is not imposed. The plaintiff must make out a case for the issuance of an injunction by demonstrating that there is a clear present need for it. Injunctions will not be issued merely to allay the fears and apprehensions or to soothe the anxieties of the parties. . . .'" [30]

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[29] There is not even evidence to support the Court's finding that plaintiffs must transfer to London 75%, as opposed to, for example, 50%, of the purchase price received from customers (see Op. 3, 15).

[30] Plaintiffs have similarly failed to satisfy their burden of showing that the possible harm to their private interests outweighs the injury to the public interest resulting from the issuance of an injunction. Although the Court found (Op. 15) that the public interest would not be adversely affected because of the other regulations which were in effect and were about to go into effect, none of those regulations serve to insure that a public customer can obtain a return of his initial investment in the event of the dealer's insolvency. The segregation provision is the linchpin of the regulatory scheme under which the Commission determined to permit options transactions to continue in this

(footnote continued)

Plaintiffs' affidavits are similarly devoid of competent evidence concerning their claims on the merits of the segregation requirement. Their averments that the guarantees and "segregation" in London inure to the benefit of option customers in the United States, as well as representations that, in the event of a plaintiff's insolvency, customers may exercise their options through another dealer, have been advanced without personal knowledge, rest on pure hearsay, and are substantially in error, as we have shown above.[31/] See Reeves v. American Optical Co., 408 F.Supp. 297 (W.D.N.Y. 1976).

In any event, since the Commission has unambiguously disputed all of plaintiffs' essential claims, the Court was required to hold an evidentiary hearing rather than rely solely on affidavits. See Securities and Exchange Commission v. Frank, 388 F.2d 486 (2d Cir. 1968) (preliminary injunction reversed for failure to afford defendant a hearing). Accord, Sims v. Greene, 161 F.2d 87, 88 (3d Cir. 1947), cited with approval in Dopp v. Franklin National Bank, 461 F.2d 873, 879 (2d Cir. 1972). As the court in Sims explained, supra, 161 F.2d

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30/ (footnote continued)

country; the other regulatory provisions were designed to complement segregation. For example, the standard and computation of net capital was made less stringent than in earlier proposals because a segregation requirement was included in the scheme. The effect of the injunction against segregation is thus to allow inadequately capitalized firms to operate with the consequent risk to the public of insolvency. As the Court stated in Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d, 921, 925 (D.C. Cir. 1958), "The interests of private litigants must give way to the realization of public purposes."

[31/] See, e.g., Affidavit of Charles J. Hecht, dated December 3, 1976, para. 12; Affidavit of James Carr, dated December 6, 1976, para. 2, 3, 4.

at 88,

> "If witnesses are not heard, the trial court will be left in the position of preferring one piece of paper to another."

## CONCLUSION

For the foregoing reasons, the Commission's Motion for Reconsideration should be granted: the Court's Order of January 4, 1977, should be vacated insofar as it granted plaintiffs' motion for a preliminary injunction against enforcement of the segregation provision (Section 32.6) and to that extent denied summary judgment to the Commission, and summary judgment should be granted in favor of the Commission with respect to the validity of the segregation requirement. Alternatively, the Court should vacate the preliminary injunction and order the prompt holding of an evidentiary hearing to resolve disputed issues of fact.

Respectively submitted,

Howard Schneider

Howard Schneider
General Counsel

Richard E. Nathan
Deputy General Counsel

Frederic T. Spindel
Pat G. Nicolette
Associates General Counsel

Charles E. Hord, III
Virginia F. Crisman
Loren W. Hershey
Attorneys

Attorneys for Defendant
Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D.C. 20581

January 10, 1977

EXHIBIT A

A-582 582

EXHIBIT A

THE LONDON COMMODITY EXCHANGE COMPANY LIMITED
REGISTERED IN LONDON - NUMBER 644268

EXHIBIT "A" TO MEMORANDUM IN SUPPORT

DIRECTORS
A. J. P. WOODHOUSE (CHAIRMAN)
D. ST. C. HARCOURT (VICE-CHAIRMAN)
A. T. BOWYER
W. BRIGHTON
P. J. DAY
G. M. HOCHTON
A. C. D. LAUGHLIN
R. E. LIDDIARD
J. F. SCHRAGER
M. STOCKDALE
N. D. C. WILKES
R. P. WINDSOR
P. A. S. RUCKER (EXECUTIVE DIRECTOR)

REGD. OFFICE ~~CEREAL HOUSE~~
58 MARK LANE
LONDON
E.C.3

TELEPHONE: 01-488 3736/9

TELEX: 884370

MGS/BLB

C.F.T.C.
2033 K Street, NW.,
Washington, D.C.
U.S.A.

1st October 1976

Attention Mr. John V. Rainbolt II.,

Vice-Chairman

Dear Mr. Rainbolt,

COMMODITY OPTIONS

Through the ICCH, we have received a copy of the Directive to Staff to draft regulations governing transactions in commodity options. We understand that this Direction was dated 13th September.

The Directive makes numerous specific references to foreign boards and the London Commodity Exchange (which as you know has formed a sub-committee under my Chairmanship specifically to consider CFTC regulatory requirements) would like to comment in detail.

You will know from contact with the LCE and the ICCH over a period of time that both these bodies support the effort to secure maximum customer protection. We believe that the detailed proposals set out below meet all the CFTC required criteria and conform to that which is possible within the constitution and practice of the bodies concerned.

Paragraph 2 on page 3 of the CFTC Directive envisages trading in options through, and subject to, the rules of foreign boards of trade recognised by the Commission as a "foreign options system", by or through a U.S. member thereof.

Paragraph 11 on page 5 deals with the segregation of premiums with the exception of foreign board of trade options for which the Commission has accepted an equivalent segregation.

Taking these paragraphs and other references to foreign boards of trade into consideration, the manner in which the market associations of the London Commodity Exchange operate, together with the activity of the ICCH, provides thorough protection on the understanding that:

(1) The U.S. FCM is a member of the ICCH and clears its own contracts (as envisaged by the Directive) and

(2) Separate clearing accounts at the ICCH are maintained by the FCM for customer business segregated from proprietory option trades and other Futures business. This is analogous to the well-proven segregation procedures for the U.S. Commodity Exchanges.

THE LONDON COMMODITY EXCHANGE COMPANY
REGISTERED IN LONDON - NUMBER 734258

DIRECTORS:
A. J. P. WOODHOUSE (CHAIRMAN)
D. ST. C. HARCOURT (VICE-CHAIRMAN)
A. L. BOWMER
W. BRIGHTON
P. J. DAY
G. M. HOGHTON
A. C. D. LAUGHLIN
R. E. LIDDIARD
J. F. SCHRADER
M. STOCKDALE
N. D. C. WILKES
R. R. WINDSOR
P. A. S. RUCKER (EXECUTIVE DIRECTOR)

REGD. OFFICE CEREAL HOUSE
58 MARK LANE
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E.C.3
TELEPHONE: 01-488 3736/9
TELEX: 884370

A-583

1st October 1976

C.F.T.C.
U.S.A.

Attention Mr. John V. Rainbolt II.

Vice Chairman

(3) In the event that the CFTC appoints a liquidator of an FCM such liquidator will be duly authorised to instruct the ICCH, who will accept such instructions, to transfer option contracts held within the defaulting FCM's. segregated customer account to another registered FCM.

You will appreciate that once an option is purchased by a customer this option carries with it rights which extend to the acceptance if demanded by the "taker" of delivery of the underlying commodity.Once the option contract has been concluded, there can clearly be no segregation of the premium since it is the consideration which was paid to the "grantor" against the transfer of rights. Having said that, however, it is a fact that the ICCH holds the premiums in the "grantors" premium account until either the option is exercised or until maturity of the option contract. Further, whilst the ICCH regulations do not permit the drawing down of profit margins, grantors of options are called for adverse margin cover under the daily clearing system. By virtue of its composite arrangements the ICCH guarantees to the clearing house member (in this case in the U.S.A.) the performance of all contracts traded on the floor of one of the LCE exchanges and cleared through the ICCH.

The transactions are registered and computerised records are promptly available.

It is our contention that provided the status of the FCM and its clearing account conform to the conditions mentioned above, the customer is fully protected.

The ICCH have indicated that if regulations governing London option business are drawn along these lines, any applicant for ICCH membership arising from the requirement, would be considered according to normal strict ICCH criteria, which for firms in the U.S.A. usually requires the applicants to be a member of one or more Commodity Clearing organisations.

We believe that the crucial points of the Directive are covered by the above. However the following additional points are pertinent:-

Continued 3

A-584

REGISTERED IN LONDON - NUMBER 644768

DIRECTORS
A. J. P. WOODHOUSE (CHAIRMAN)
D. ST. C. HARCOURT (VICE-CHAIRMAN)
A. L. FOMMER
W. BRIGHTON
P. J. DAY
G. M. LOGHTON
A. C. D. LAUGHLIN
R. E. LIDDIARD
J. F. SCHRADER
M. STOCKDALE
N. D. C. WILKES
R. R. WINDSOR
P. A. S. RUCKER (EXECUTIVE DIRECTOR)

REGD. OFFICE CEREAL HOUSE
58 MARK LANE
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TELEPHONE: 01-428 3736/9
TELEX: 884370

C.F.T.C.
U.S.A.

1st October 1976

Attention Mr. John V. Rainbolt II.,

Vice-Chairman

(a) Paragraph 1(b) page 3. The ICCH guarantee extends only to the Clearing Member in whose name the contracts are registered, as in the case of U.S. contract markets.

(b) Paragraph 7(n) page 4. The ICCH will be able to register option contracts in a single FCM account confined to customer dealing. We suggest that it should be incumbent upon the FCM to keep its own records of the breakdown into individual accounts of their obligations to these individuals.

(c) Paragraph 8 page 4. ICCH computer records are available on a daily basis and presumably can be made available by the FCM to CFTC inspection and verified by the ICCH if necessary.

(d) Paragraph 11 page 5. Profits are understood by the ICCH to be the daily credit margin as between the striking price and the days closing level of the commodity in question. The record of this margin is shown in the ICCH computer records. Profit margins cannot be drawn down under the ICCH regulations until the futures contract is liquidated after an option exercise.

(e) Paragraph 6 page 6. The precise rules governing option business are laid down by the rules of the various associations who form part of the ICE. These can be summarised by separate letter if required. The ICCH and the ICE is equally concerned with the CFTC to ensure that liquidation of option positions is orderly and not detrimental to the futures and cash markets. Trading in options in the U.K. forms a natural part of trade participation in hedging their natural actual requirements.

We have sent a copy of the Directive and of this reply to the Bank of England under whose special permissions the London commodity markets operate. We have also sent copies to Lord Bridges, Minister of Commerce at the British Embassy in Washington.

Continued 4

THE LONDON COMMODITY EXCHANGE COMPANY LIMITED

REGISTERED IN LONDON - NUMBER [illegible]

DIRECTORS:
A. J. P. WOODHOUSE (CHAIRMAN)
D. ST. C. HARCOURT (VICE CHAIRMAN)
A. L. BOW[illegible]ER
W. BRIGHTON
P. J. DAY
G. M. HOGHTON
A. C. D. LAUGHLIN
R. E. LIDDIARD
J. F. SCHRADER
M. STOCKDALE
N. D. C. WILKES
R. R. WINDSOR
P. A. S. RUCKER (EXECUTIVE DIRECTOR)

REGD. OFFICE CEREAL HOUSE
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TELEX: 884370

A-585

C.F.T.C.
U.S.A.

1st October, 1976.

Attention of Mr. John V. Rainbolt II

Please note that this letter refers only to those commodities whose associations form part of the LCE and where ICCH clearing arrangements are in operation.

It is our belief that the viability of the international commodity market does depend to a large extent on futures business placed on and between the U.S. and U.K. markets. We therefore urge your careful consideration of the points we have raised in order to ensure that the historic connection between the U.S. and the U.K. in this respect is maintained.

We should be grateful to have your acknowledgement of this communication by telex and would appreciate your confirmation that our proposals are acceptable failing which we should wish to make further immediate representations, to the Commission and other U.S. and U.K. governmental entities concerned with the maintenance of commerce between our respective countries.

Yours sincerely,

L.A. BRIGHTON,
Chairman LCE/CFTC Liaison Sub-Committee.

C.C. Mr. H. SCHNEIDER
General Council.

Dr. M. POWERS
Chief Economist.

Mr. C. [illegible]
Administrative Assistant
to Vice-Chairman.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP., et. al,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, et. al,

Defendants.

MEMORANDUM IN OPPOSITION
TO DEFENDANTS' MOTION
TO REARGUE

76 Civ 5124 (WK)

This memorandum is submitted by the plaintiffs British American Commodity Options Corp. and Lloyd, Carr & Co. in opposition to the defendants' motion for reconsideration filed January 10, 1977 and memorandum in support thereof.[1,2]

The basic prerequisites to the entertainment of a motion for reconsideration are that the Court misapprehended the controlling law or was mistaken as to the material facts.[3,4,5] The defendants' present reassertion of the same arguments in an attempt to persuade the Court to change

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[1] The defendants have not responded to plaintiffs' motion for a stay pending appeal or in the alternative, reconsideration of the Court's rulings on minimum financial requirements or registration as an FCM.

[2] This motion, which is scheduled for argument on January 12, 1977, was not filed in accordance with Rule 6(d) of the Federal Rules of Civil Procedure.

[3] Brown v. Texas and Pacific Railroad Co., 392 F.Supp. 1120 (D.C. La. 1975); Solar Laboratories v. Cincinnati Advertising Products Co., 34 F.Supp. 783 (D.C. Ohio 1940).

its mind is totally insufficient and accordingly, the defendants' motion should be dismissed out of hand.[6]

The critical fact, which is not refuted by the CFTC, is that plaintiffs act as agents and, thus, the requirement of "double segregation" has no relationship to the nature of their business or the protection of investors. The unrefuted fact is that plaintiffs and persons similarly situated do not hold customers' funds but promptly transmit such funds to others (the clearing member on a purchase and the customer on a close out). Commodity options are purchased

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4. The Court did not consider the position of the two named plaintiffs in this case that the registration provisions of Reg. 32.3 as promulgated violate 5 U.S.C. §706. Reference is made to paragraph 8 of the affidavit of Charles J. Hecht dated December 30, 1976.

5. The defendants misrepresented in their papers and in open Court the interpretation of the minimum financial requirements contained in Reg. 1.17, stating a position, on which the Court relied in its decision, diametrically opposed to their real interpretation of these regulations as evidenced by the actions of their staff in the field. See Exhibit "C" and the attachment thereto to the motion filed on December 30, 1976.

6. The plaintiff Lloyd, Carr & Co, which was formed in July, 1976, is already registered as a commodity trading advisor and intends to obtain an extension of time to file as an FCM because it is now required to retain an accounting firm to make the alternative minimum financial requirements calculation (normally the accountants would only have been required at the close of its first fiscal year on June 30, 1977). Based upon information and belief, all of the other named plaintiffs, exclusive of British American, are registered as commodity trading advisors with the CFTC. British American filed its CTA application in March, 1976 and under the ruling of Judge Gagliardi in 76 Civ 3247 on October 20, 1976, is permitted to continue its operations.

for cash and not on margin and, thus, the dealer is not required to advance its funds for its customers.[7] Simply stated segregation, and for that matter the true minimum financial requirements, are totally unrelated to proper regulatory objectives or the actual operations of plaintiffs herein as their real purpose is to eliminate all present retail commodity option dealers from the commodity option industry.

The Court's order of January 4, 1977 refers to plaintiffs who act as agents, the Court deliberately omitting the words "for a London principal." The Court throughout its opinion emphasized that plaintiffs act as agents, and not principals. The plaintiffs do not sell options on margin nor in any way do they use their customers' funds for any purpose other than to transmit the cost of the premium (retaining their commission) promptly and directly to their clearing broker, a member of the International Commodities Clearing House ("ICCH") or the London Metal Exchange ("LME"), for the purchase of an option. The defendants, seizing upon the term "agents for London principals", would becloud the fact that plaintiffs are agents in order to induce the Court to treat them as principals who sell on margin.

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[7] The provisions of 7 U.S.C. §6d(2) to which the defendants refer are clearly inapplicable as covering money received "to margin, guarantee, or secure the trades or contracts of" customers, activities not engaged in by plaintiffs.

Segregation would only be of benefit and protection to the customers of a dealer writing naked options, which as everyone knows is the fraudulent technique utilized by Goldstein-Samuels which gave rise to the substantive amendments to the Commodity Exchange Act of 1974 and the creation of the CFTC.[8]

At page 9 the defendants have inadvertantly admitted that the appropriate solution, which has been advocated and used by the plaintiffs herein without any guidance from the defendant, is to provide a proper mechanism in the event the dealer is unable to effectuate the close out to enable the customer to promptly and efficiently close out his transaction with another dealer. This is the most complete and effective investor protection.

The letters of the London Commodity Exchange Company Limited dated October 1, 1976 and November 1, 1976 annexed to defendants' memorandum in support of their motion for reconsideration in fact support plaintiffs' position that the "double segregation" which the defendants seek to impose would be punitive without effecting any benefit. The defen-

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8. The cases cited in footnote 10 at page 8 of defendants' motion to reargue are totally unrelated to the concept of segregation (also see footnote 14 at page 12). The cases cited in the second paragraph of such footnote were all on consent. On the other hand, as previously shown to the Court, the two cases on alleged violations of the anti-fraud provisions, also unrelated to "naked options", which were actually litigated by the CFTC, resulted in the denial of injunctions.

dants' comments, based upon the fact that the ICCH and LME guarantees run only to the clearing member, ignore the reality that the dealer such as plaintiffs and their customers are clearly third party beneficiaries of such guarantees. The CFTC does not have the honesty or integrity to concede the financial capability and stability of the ICCH and LME and its constituent members.

Plaintiff British American has consistently advocated regulation, including a minimum capital test rationally related to the method of operations--to wit, an absolute minimum of $50,000 to $100,000, as distinguished from the alternative test in Reg. 1.17 which has no relationship to the protection of the dealer's customers or the operations of plaintiffs herein. The defendants have omitted to mention that substantially all of the existing retail commodity option dealers are now registered as CTAs with the CFTC and are subject to certain existing regulations.

The hardships of double segregation on existing dealers is conceded. Howard Schneider (General Counsel) acknowledged during oral argument on December 10, 1976 that double segregation would have the effect of putting all existing dealers out of business as only existing broker-dealers with substantial free capital would be permitted in this industry. As the plaintiffs properly perceived at the outset (see comment letter of Charles J. Hecht to CFTC dated November 4, 1976), the true purpose of these regulations was to give an oligopoly to the five largest securities broker-dealers, who have no prior experience or invested capital in developing this business. Even as to those select few, it would be a significant hardship as it would require them to tie up substantial capital without serving any useful purpose to anyone.

Irreparable harm is self-evident (i.e., for every $1.00 received from customers, the dealer must lay out $3.50). The defendants' position that one must be put out of business before seeking equity protection from the courts. is completely untenable. The defendants' present afterthought of attempting to impose the requirement of an evidentiary hearing for a preliminary injunction in this type of case where a pre-enforcement review of regulations is sought and where there are no contested factual issues should not be sustained.[9] The instant case is clearly distinguishable from S.E.C. v. Frank, 3[illegible]8 F.2d 486 (2d Cir 1968), where the defendants were individuals being enjoined from earning a livelihood, and Sims v. Greene, 161 F.2d 87 and Dopp v. Franklin National Bank, 461 F.2d 873, 879 (2d Cir. 1972), where there were conflicting factual allegations. In the instant case the only dispute is as to whether or not Reg. 32.6 is reasonable and justified for the public protection; there is no dispute as to what that regulation requires.

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[9] Defendants represented to this Court in their Rule 9 motion for summary judgment that there was no dispute of material facts. The defendants are also the party that asked for a substantial extension in November to file its papers and announced on December 22, 1976 that they would move for reconsideration and did not serve their papers until the late afternoon of January 10, 1977.

The defendants represent the very same agency

(i) which attempted to sneak through similar regulations on November 20, 1976 and was only halted by the filing of an action by the plaintiffs herein;

(ii) whose "revised regulations" published on November 24, 1976 contained an abbreviated time schedule;

(iii) which upon information and belief is failing expeditiously to process the FCM and associated persons applications so that on January 17, 1977 it can take the position that those not yet registered must cease operations;

(iv) which in its brief of December 8, 1976 and at oral argument on December 10, 1976 stated that no haircuts were required as to customers' unrealized equity and at the same time is rejecting applications because they are taking the position in the field that Reg. 1.17 requires both a 5% haircut on the liability side of the balance sheet as to customers' equity plus a 5% haircut on the asset side since customers' equity represents unsecured accounts receivable;

(v) whose chairman stated in the press that the Court's decision on segregation was "facetious"; and

(vi) which has arrogantly threatened to ban all commodity options if the Court did not change its decision on segregation.

WHEREFORE, the undersigned on behalf of the plaintiffs herein respectfully requests that the Court grant plaintiffs' motion for a stay pending appeal or in the alternative, as to FCM registration and minimum financial requirements, reconsideration based on after-discovered facts and deny the defendants' motion for reconsideration in its entirety.

Dated: January 11, 1977
New York, New York

Respectfully submitted,

Charles J Hecht

Charles J. Hecht
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Of Counsel:

Haig Costikyan, Esq.
Martin H. Kaplan, Esq.,
of Gusrae, Greene & Kaplan

## AFFIDAVIT OF DAVID GREENE

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF [illegible] YORK

------------------------------------------x

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & CO.,

Plaintiffs,

76 Civ. 5124

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

------------------------------------------x

AFFIDAVIT OF NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS IN OPPOSITION TO DEFENDANTS' MOTION FOR RECONSIDERATION

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTION INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs,

76 Civ 2250

- against

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, III, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, COMMISSIONER COMMODITY FUTURES TRADING COMMISSION,

Defendants.

------------------------------------------x

STATE OF NEW YORK )
:ss:
COUNTY OF NEW YORK )

DAVID GREENE, being duly sworn, deposes and says:

1. I am local counsel to the NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS ("NASCOD"), Plaintiffs in the consolidated action as captioned above.

2. Your deponent submits this affidavit in opposition to the Defendants' motion for re-consideration of the order of January 4, 1977 of this Court which, inter alia, preliminary enjoined the COMMODITY FUTURES TRADING COMMISSION ("CFTC") from enforcing the segregation requirements contained in Section 32.6 of the commodity options regulations adopted by the Commission, 41 FED. REG. 51808 (November 24, 1976) against any Plaintiff who is in the business of selling commodity options as an agent for a principal.

3. It is respectfully submitted that the above referred to motion for re-consideration by the Defendants CFTC should not be considered by this Court as the motion fails to meet the requirements of Rule 6(d) of the Federal Rules of Civil Procedure, as well as fails to comply with Rule 9 of the local rules of the United States District Court, Southern District of New York.

4. It is further respectfully submitted that there has still been no factual showing of need for the CFTC's rules regarding

segregation and it has still not been explained how the segregation rule protects the customer from obtaining the benefit of its bargain. Moreover, and characteristically, the CFTC in its numerous conflicting approaches taken in the past year to the problem of providing rules and regulations in the commodity options field, has demonstrated that the CFTC is not fully acquainted with the actual "nuts and bolts" of what commodity options are all about. Further, as the Court noted on page 14 and 15 of its opinion, Congress apparently has failed to provide any standards to guide the C.F.T.C. The opinion of the Court sets forth that "whether or not such failure to provide standards could be said to invalidate this portion of the legislation...such failure should at least be deemed to impose on the Commission the obligation of taking particular pains to insure that its rule making will not be arbitrary and capricious." Lastly, your deponent submits that the only one of the CFTC's approaches which was finally promulgated was without an opportunity for full public hearings.

5. It should be noted that deponent, as local counsel for NASCOD, hereby joins in Plaintiffs,' BRITISH AMERICAN COMMODITY OPTIONS CORP and LLOYD CARR & CO.'s motion for a stay, staying the enforcement by the Defendants of certain sections of the regulations, more particularly, Section 32.3, Rule 1.17 and Rule 1.19, pending appeal.

WHEREFORE, you deponent respectfully requests that the application for re-consideration of the order of this Court dated January 4, 1977 be denied.

Respectfully,

/s/

DAVID GREENE
GUSRAE, GREENE & KAPLAN
Attorneys for NASCOD
67 Wall Street
New York, New York 10005
(212) 269-1400

Sworn to before me this

12th day of January, 1977.

77

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRITISH AMERICAN COMMODITY OPTIONS
CORP., ET AL.,

Plaintiffs,

v.

WILLIAM T. BAGLEY, ET AL.

Defendants.

NATIONAL ASSOCIATION OF COMMODITY OPTION
DEALERS, ET AL.,

Plaintiffs,

v.

COMMODITY FUTURES TRADING COMMISSION, ET AL.,

Defendants.

Civil Action No.
76 Civ. 5124 (WK)
(Consolidated)

## DEFENDANTS' MEMORANDUM IN OPPOSITION TO PLAINTIFFS' MOTION FOR A STAY PENDING APPEAL AND ITS SUGGESTION FOR RECONSIDERATION

On January 4, 1977, this Court issued an Order pursuant to its Memorandum Opinion of December 21, 1976, preliminarily enjoining the Commission from enforcing its rules requiring segregation (section 32.6) against any plaintiff who is in the business of selling options as an agent for a principal, but granted the Commission's motion for summary judgment on plaintiffs' challenge to all other commodity option regulations adopted by the Commission in 41 Fed. Reg. 51808 (November 24, 1976).

Plaintiffs have now moved this Court, in effect, to enjoin enforcement of the balance of the Commission's rules pending appeal to the United States Court of Appeals for the Second Circuit.[1/] They also suggest that the Court may wish to reconsider those portions of its decision relating to the rule on minimum financial requirements (section 32.3 and regulation 1.17) and registration (section 32.3 and regulation 1.19).

This Memorandum is submitted in opposition to plaintiffs' motion.

## I. THE PLAINTIFFS HAVE NOT SATISFIED THE HEAVY BURDEN IMPOSED UPON PERSONS SEEKING AN INJUNCTION PENDING JUDICIAL REVIEW.

In order to justify the granting of an injunction pending appeal, the plaintiffs must make:

1) A strong showing that they are likely to prevail on the merits of their appeal;

2) A showing that absent an injunction, they will suffer irreparable injury;

3) A showing that the issuance of an injunction will not substantially harm other persons interested in the proceedings; and

4) A showing that there will be no harm to the public interest if an injunction is granted. [2/]

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[1/] Plaintiffs have requested a "stay" pending appeal. We assume, however, they mean to file this motion pursuant to Rule 62(c) of the Federal Rules of Civil Procedure, wherein "the court in its discretion may . . . grant an injunction during the pendency of [an] appeal . . . ." We note that plaintiffs have yet to notice an appeal from the Court's Order.

[2/] See, e.g., Eastern Airlines, Inc. v. Civil Aeronautics Board, 261 F.2d 830 (2d Cir. 1958) and Virginia Petroleum Jobbers Association v. Federal Power Commission, 259 F.2d 921, 925-926 (D.C. Cir. 1958); Atlantic Richfield Company v. Federal Power Commission, 398 F. Supp. 1 (S.D. Tex. 1975); Roe v. Ferguson, 389 F. Supp. 393 (S.D. Ohio 1974); Stop H-3 Association v. Volpe, 353 F. Supp. 14 (Haw. 1972).

Plaintiffs have not shown that any of the above criteria are met, much less demonstrated that all of them exist, which is the heavy burden they must sustain.

The plaintiffs have failed to state any basis upon which they intend to appeal. Nor have they set forth any error on the part of the Court which demonstrates a likelihood of success on the merits of an appeal.

This Court has already considered, and emphatically rejected (Op. 15-18), plaintiffs' various contentions[3/] concerning: (1) the Commission's compliance with the Administrative Procedure Act--i.e., the requirements for public comment; whether the Commission's actions were unsupported by substantial evidence; and whether the minimum financial and the disclosure requirements adopted by the Commission are arbitrary and capricious; (2) the Commission's statutory responsibility to consider the anticompetitive effect of its regulations; and (3) whether the Commission acted in a manner consistent with Constitutional due process requirements. This Court's findings and conclusions on these issues are fully supported by the record and all pertinent judicial authorities. Plaintiffs have advanced no new facts or legal contentions upon which a reviewing court might reasonably rule otherwise. Nor have plaintiffs shown any significant injury either to themselves or to others if the rules should be permitted to go into effect. Moreover, on three previous occasions this Court has held that plaintiffs will not be irreparably injured by complying

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[3/] See, Affidavit of Charles Hecht, ¶¶5, 9 (December 30, 1976).

with the Commission's registration and disclosure requirements and nothing in their moving papers reflects that circumstances have changed. Since this Court has enjoined the implementation of the segregation provisions, compliance with the balance of the option rules will, at most, subject plaintiffs to nominal expenses which may easily be passed on to their customers. In any event, mere financial injuries, however substantial, even if suffered, are insufficient to warrant an injunction against administrative action:

> "Serious as [an] injury may be, it is not of controlling importance as primary consideration must be given to the statutory intent to protect investors." 4/

The public interest in enforcing these regulations clearly outweighs the interests of plaintiffs, who, in any event, may continue to engage in their options business. The public interest would not be served, and in fact would be severely impaired, by enjoining implementation of these rules, designed to protect members of the investing public, which the Court has already found to be valid. In issuing a preliminary injunction against enforcement of the segregation requirements, the Court expressly relied upon the fact that there were "a wide panoply of regulations already and about to be in effect" providing customer protections (Op. at 15). Plaintiffs would now

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4/ Associated Securities Corporation v. Securities and Exchange Commission, 283 F.2d 773 at 775 (10th Cir. 1960). See also Allen v. Grand Central Aircraft Company, 347 U.S. 535 (1954), Yakus v. United States, 321 U.S. 414 (1943), Scripps-Howard Radio v. Federal Communications Commission, 316 U.S. 4 (1942), Myers v. Bethlehem Shipbuilding Corp., 303 U.S. 41 (1938).

have this Court strip the public even of these protections while they leisurely pursue an unmeritorious appeal. Such a result should not be permitted.

None of the other contentions addressed by plaintiffs are relevant to its application for an injunction pending appeal. Plaintiffs profess concern for the interests of their customers in urging this Court to enjoin regulations designed for customer protection (Hecht Aff. ¶12). Their claim lacks credibility, however, since they have vigorously resisted having to comply with disclosure requirements and minimum financial requirements and have emphasized their own interests in having sought and obtained an injunction against having to segregate funds for the protection of their customers. In addition, plaintiff British American has been violating the Commodity Exchange Act since its inception by failing to register as a commodity trading advisor.[5/]

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[5/] While Judge Gagliardi, in his discretion, declined to enjoin this violation, it is clear from his opinion, and appendix thereto, that the violation continues. CFTC v. British American Commodity Options Corp., CCH Fed. Comm. Fut. L. Rep. ¶20,224 (S.D.N.Y., 76 Civ. 3247, Oct. 20, 1976).

Since Judge Gagliardi plainly intended no interference with the Commission's administrative processes concerning whether British American may be registered under the Commodity Exchange Act, there is no basis for plaintiffs' suggestion (Hecht Aff. ¶8) that his opinion would be "unilaterally reverse[d]" if it should ultimately be found by the Commission that British American is not qualified under applicable regulations to offer commodity options to the public. To the extent plaintiffs suggest the Commission will act arbitrarily and capriciously in refusing to register them or in granting an appropriate exemptive request, the Commission has already responded to this contention in the Commission's Memorandum in Support of Its Motion for Summary Judgment, dated December 7, 1976, p. 42.

In addition, plaintiffs seem to take personally the Commission's attempts generally to warn the public about fraudulent activities in the commodity option industry and its attempts to alert the public how to discern when sharp practices are being followed (Hecht Aff. ¶¶10, 11; Aff. of John Forma ¶¶2 and 4).[6/] But the Commission's effort to fight fraud through public education provides no basis upon which this Court may enter an injunction pending appeal or upon which it should reconsider its ruling on the propriety of the Commission's regulations other than segregation.

Nor is it relevant to the issues at bar that if the segregation requirement is held unenforceable the Commission will have to consider other approaches to investor protection--including, possibly, banning commodity option trading. Counsel's suggestion (Hecht Aff. ¶2) that the Commission's recognition of this duty is somehow an "insult to the integrity of this Court and the entire judicial system," reflects an insensitivity to the proper relationship between the courts and administrative agencies concerning regulatory matters. While the courts have a duty to assure that agencies act in accordance with the

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[6/] Plaintiffs also ask that their customers be subjected to unnecessary risks merely to assist the plaintiffs to compete on more favorable terms with firms that offer other forms of investment (Hecht Aff. ¶9).

law, so long as it does so the agency is free to exercise its discretion within the area of regulatory authority entrusted to it by Congress.[7/]

## II. THERE IS NO MERIT TO PLAINTIFFS' SUGGESTION THAT THE COURT RECONSIDER ITS RULING ON THE MINIMUM FINANCIAL AND REGISTRATION REQUIREMENTS OF THE OPTION REGULATIONS.

In its Memorandum Opinion of December 21, 1976, this Court rejected plaintiffs' attack upon the minimum financial requirements imposed under the option regulations. This decision was based, in part, upon the Court's conclusion that the plaintiffs' "arguments against the minimum financial requirements were grounded upon a misunderstanding of the Commission's regulation."

Counsel now asserts (Hecht Aff. ¶4) that the Commission "misinformed the Court concerning the proper interpretation of the rules." He emphasizes an inconsistency between the interpretation given to this Court and an interpretation of that regulation reflected in a letter that was earlier written by a Commission employee. The letter counsel relies upon was written shortly after the adoption of the Commission's option rules, however, and before the interpretative position presented to this Court had been formulated. Accordingly,

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[7/] Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402 (1971); United States v. Pierce Auto Freight Lines, 327 U.S. 515 (1946); General Transportation Co. of Southwest v. United States, 449 F. 2d 846 (5th Cir., 1971); Automotive Parts & Accessories Assn. v. Bogel, 467 F. 2d 330 (D.C. Cir. 1968), cited with approval, National Nutritional Foods Assn. v. Weinberger, 512 F. 2d 688 (2d Cir. 1975); Mulry v. Driver, 366 F. 2d 544 (9th Cir. 1966).

that letter is not "typical" of the current position taken, as counsel erroneously asserts (id. ¶5); rather, the Commission's staff has since been following the interpretation of which this Court was advised.[8/]

In any event, there is no basis upon which this Court may or should prefer the views of a Commission employee to the views of the Commission, as presented by its General Counsel and Associate General Counsel. The Court of Appeals for this Circuit has found it appropriate to rely heavily upon the interpretive views of an agency as expressed by counsel, recognizing that "[t]he interpretation of a regulation or statute by a regulatory agency that is charged with administering it is given considerable deference by federal courts . . . so long as it is not clearly unnatural or unreasonable." Perine v. William Norton & Co., Inc., 509 F. 2d 114, 120 (2d Cir., 1974). In contrast, the views of subordinate agency employees are not relied upon by the courts as necessarily reflecting the views of the agency itself.[9/]

Plaintiffs also reiterate their claim (Hecht Aff. ¶8) that under Regulation 1.19 option dealers who register as futures commission merchants would be "prohibit[ed] from trading in commodity options. . . ." As the Commission showed at p. 48 of its Memorandum in Support of its Motion for Summary Judgment, however,

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[8/] See Affidavit of Edward F. O'Brien attached as Exhibit A hereto.

[9/] Kixmiller v. Securities and Exchange Commission, 492 F. 2d 641 (D.C. Cir. 1974); International Paper Co. v. Federal Power Commission, 438 F. 2d 1349 (2d Cir. 1971); National Automatic Laundry & Cleaning Council v. Shultz, 443 F. 2d 689 (D.C. Cir. 1971).

that regulation merely prohibits futures commission merchants from assuming financial responsibility for an option, but leaves them free to buy options as agents for their customers. Since it appears from the record (see Memorandum in Support of Plaintiffs' Motion for a Declaratory Judgment and Preliminary Injunctions, etc., dated December 9, 1976, pp. 2-8) and from Mr. Hecht's affidavit itself (¶6) that plaintiff's business is conducted solely on an agency basis, they can hardly claim that this provision subjects them to any present risk or inconvenience.

## CONCLUSION

For the foregoing reasons, plaintiffs' motion for a stay pending appeal and their suggestion that this Court reconsider certain matters should be denied.

Respectfully submitted,

HOWARD SCHNEIDER
General Counsel

RICHARD E. NATHAN
Deputy General Counsel

FREDERIC T. SPINDEL
Associate General Counsel

FRED M. SANTO
Attorney

VIRGINIA F. CRISMAN
Attorney

Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D. C. 20581
(202) 254-9880

January 12, 1977

EXHIBIT "A" TO MEMORANDUM IN OPPOSITION

Exhibit A

Edward F. O'Brien being duly sworn, deposes and says:

1. I am an accountant employed by the CFTC in the position of Associate Director of the Commission's Division of Trading and Markets, in the Washington Office of the Commodity Futures Trading Commission, 2033 K Street, N.W., Washington, D.C. 20581. In that capacity, I have overall supervisory responsibility for the nationwide audit program of the Commission. I have been employed by the Commission and its predecessor agency, the Commodity Exchange Authority, both as an auditor and a supervisory auditor since 1956.

2. Prior to November 24, 1976, the date the Commission adopted its interim regulations relating to commodity option transactions, persons engaged in London commodity option transactions were not required to register as futures commission merchants (FCMs). Because of the Commission's interim option regulations, such registration will be required on and after January 17, 1977. As a result, the Registration Unit of the Commission's Division of Trading and Markets has been recently experiencing a noticable increase of FCM applications from persons engaged in, and wishing to become engaged in, the sale of commodity options in the United States.

3. As a direct result of the Commission's interim option regulations, meetings of the Commission's auditing staff were held in our New York Regional Office on November 18 and 19, 1976, and in our Chicago Regional Office on Novembre 30, December 1 and 2, 1976. I presided at each meeting. The purpose of these meetings was to discuss problems related to commodity option trading, the Commission's interim regulations, and how those problems would affect the Commission's audit pro-

gram. Until that time, the Commission's auditing staff, under my supervision, followed a procedure in relation to the treatment by FCMs of unrealized gains on customers' open option contracts, for minimum capital requirement purposes in Regulation 1.17, whereby any such gains which were receivable from a London option clearing broker were subject to a 5% charge against the stateside broker's working capital; and the corresponding payable due to the ultimate customers was made a part of the stateside broker's aggregate indebtedness. Among the problems discussed at the auditors meetings was this procedure. On December 2, 1976, the auditing staff agreed that if an FCM were acting in an agency capacity in the purchase of a commodity option for a commodity option customer, any unrealized gain on such option should not be treated as a receivable to the FCM, or as a payable to its customers, for purposes of net capital computation under regulation 1.17, regardless of how such gains are treated for accounting purposes. Therefore, the receivable would not be subject to a 5% charge against an FCM's working capital, and the payable would not be included in aggregate indebtedness. This procedure has been followed by the auditing staff since December 3, 1976, and was concurred in by the Director of the Division of Trading and Markets on December 17, 1976.

4. I have read the letter signed by Mr. Marvin Jackson of our New York Regional audit staff which was sent to Crown Colony Commodity Options Ltd., on December 1, 1976 attached to the affidavit of David Weingless submitted to the Court. That letter was drafted by Mr. Barn

Gelber of the same regional staff several days prior to the date it was mailed. This letter, which instructed Crown Colony to take a charge of 5% on receivables resulting from the unrealized gain on commodity option transactions, and to include the resulting payable due to commodity option customers in aggregate indebtedness, was signed by Mr. Jackson, in the absence of Mr. Gelber who was attending the Chicago auditor's meeting.

5. If it is formally concluded that Crown Colony is in fact acting as an agent, the charges applicable to unrealized gains on open option contracts will not be made a part of Crown Colony's minimum capital requirements. Steps have already been taken to ascertain whether Crown Colony is acting as a principal or as an agent.

6. In addition, at the December 2, 1976 auditor's meeting referred to in paragraph 3 above, we discussed the treatment to be afforded commodity options funds required to be segregated by section 32.6 of the option rules for the computation of adjusted working capital in accordance with regulation 1.17. At that time, it was decided that the Commission's Division of Trading and Markets should adopt a policy in computing adjusted working capital to permit the inclusion of segregated funds as a current asset on all options with an expiration date of less than one year. Inasmuch as the Commission on December 22, 1976 determined not to enforce its segregation rule against any commodity option dealer pending

reconsideration of the Court's decision in British American Commodity Option Corp. v. Bagley, S.D.N.Y., 76 Civ. 5124, no occasion for the appliation of this policy has yet arisen.

Edward F. O'Brien
EDWARD F. O'BRIEN

Subscribed and sworn to this
11th day of January, 1977

NOTARY PUBLIC

My Commission Expires August 31, 1978

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
------------------------------------------x

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & CO.,

Plaintiffs,

76 Civ. 5124

- against -

WILLIAM T. BAGLEY, Chairman of the
COMMODITY FUTURES TRADING COMMISSION;
JOHN V. RAINBOLT III, Vice Chairman of
the COMMODITY FUTURES TRADING COMMISSION;
READ P. DUNN, GARY SEEVERS and ROBERT L.
MARTIN, Commissioners of the COMMODITY
FUTURES TRADING COMMISSION,

Defendants.
------------------------------------------x

AFFIDAVIT OF NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS IN OPPOSITION TO DEFENDANTS MOTION FOR RECONSIDERATION

NATIONAL ASSOCIATION OF COMMODITY OPTION
DEALERS, a non-profit association, BRISTOL
OPTION INC., CHARTERED SYSTEMS CORPORATION,
BRITISH AMERICAN COMMODITY OPTIONS CORPORATION,
CLEARY TRADING COMPANY, INC., FIRST NEW YORK
COMMODITY OPTIONS, LTD., FIRST WESTERN
COMMODITY OPTIONS, INC. OF LOS ANGELES,
WILLISTON CORPORATION, LLOYD, CARR AND
COMPANY and INTERNATIONAL COMMODITY OPTIONS,
LTD.,

Plaintiffs,

76 Civ 2250

- against

THE COMMODITY FUTURES TRADING COMMISSION,
WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES
TRADING COMMISSION, JOHN B. RAINBOLT, III,
Vice Chairman COMMODITY FUTURES TRADING
COMMISSION, GARY SEEVERS, Commissioner COMMODITY
FUTURES TRADING COMMISSION, READ P. DUNN, JR.,
Commissioner COMMODITY FUTURES TRADING COMMISSION
and ROBERT L. MARTIN, COMMISSIONER COMMODITY FUTURES
TRADING COMMISSION,

Defendants.
------------------------------------------x

STATE OF NEW YORK )
:ss:
COUNTY OF NEW YORK )

DAVID GREENE, being duly sworn, deposes and says:

1. I am local counsel to the NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS ("NASCOD"), Plaintiffs in the consolidated action as captioned above.

2. Your deponent submits this affidavit in opposition to the Defendants' motion for re-consideration of the order of January 4, 1977 of this Court which, inter alia, preliminary enjoined the COMMODITY FUTURES TRADING COMMISSION ("CFTC") from enforcing the segregation requirements contained in Section 32.6 of the commodity options regulations adopted by the Commission, 41 FED. REG. 51808 (November 24, 1976) against any Plaintiff who is in the business of selling commodity options as an agent for a principal.

3. It is respectfully submitted that the above referred to motion for re-consideration by the Defendants CFTC should not be considered by this Court as the motion fails to meet the requirements of Rule 6(d) of the Federal Rules of Civil Procedure, as well as fails to comply with Rule 9 of the local rules of the United States District Court, Southern District of New York.

4. It is further respectfully submitted that there has still been no factual showing of need for the CFTC's rules regarding

segregation and it has still not been explained how the segregation rule protects the customer from obtaining the benefit of its bargain. Moreover, and characteristically, the CFTC in its numerous conflicting approaches taken in the past year to the problem of providing rules and regulations in the commodity options field, has demonstrated that the CFTC is not fully acquainted with the actual "nuts and bolts" of what commodity options are all about. Further, as the Court noted on page 14 and 15 of its opinion, Congress apparently has failed to provide any standards to guide the C.F.T.C. The opinion of the Court sets forth that "whether or not such failure to provide standards could be said to invalidate this portion of the legislation...such failure should at least be deemed to impose on the Commission the obligation of taking particular pains to insure that its rule making will not be arbitrary and capricious." Lastly, your deponent submits that the only one of the CFTC's approaches which was finally promulgated was without an opportunity for full public hearings.

5. It should be noted that deponent, as local counsel for NASCOD, hereby joins in Plaintiffs' BRITISH AMERICAN COMMODITY OPTIONS CORP and LLOYD CARR & CO.'s motion for a stay, staying the enforcement by the Defendants of certain sections of the regulations, more particularly, Section 32.3, Rule 1.17 and Rule 1.19, pending appeal.

WHEREFORE, you deponent respectfully requests that the application for re-consideration of the order of this Court dated January 4, 1977 be denied.

Respectfully,

David Greene

DAVID GREENE
GUSRAE, GREENE & KAPLAN
Attorneys for NASCOD
67 Wall Street
New York, New York 10005
(212) 269-1400

Sworn to before me this

12th day of January, 1977.

Martin H Kaplan

MARTIN H. KAPLAN
Notary Public, State of New York
No. 24-4519073
Qualified in Kings County
Commission Expires March 30, 1977

dwbr

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO., :
Plaintiffs, :
-against- :
WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION: : 76 Civ. 5124
JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION: READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION, :
Defendants. :

---------------------------------------- x

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD., :
Plaintiffs, : MEMORANDUM AND ORDER
-against- : 76 Civ. 2250
THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION, :
Defendants. :

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Before:

HON. WHITMAN KNAPP,

District Judge

New York, January 12, 1977
Room 905 - 5:00 p.m.

APPEARANCES

CHARLES J. HECHT, Esq.,
Attorney for Plaintiffs British American,
By: HAIG COSTIKYAN, Esq., of Counsel
MARTIN H. KAPLAN, Esq., of Counsel

GUSRAE, GREENE & KAPLAN, Esqs.,
Attorneys for Plaintiffs National Association of Commodity Option Dealers,
By: DAVID GREENE, Esq., of Counsel

HOWARD SCHNEIDER, Esq.,
Attorney for Commodity Futures Trading Commission

Also Present:

LES BLAU, Esq.
FREDERICK T. SPINDEL, Esq.

-o0o-

(In open court.)

THE COURT: I have read your papers with considerable care and I can tell you right now that I am going to deny all motions with one possible exception, and for a very simple reason. I have no function in this case to find facts.

I think I have exhausted my function in this case and whether I came to the right conclusion for the wrong reasons or the wrong conclusion for the right reasons is really irrelevant at this moment. The only way I can foul up everybody's life is to take more time.

The function of a district court in my view in this kind of a case is to focus the issue and permit the parties to make a record, a nd then be as unobstructive as possible and get the pasrties to the Court of Appeals which is where they want to be..

In the real world nobody really gives much of a hoot why I did what I did or don't do what I do.

If there were a question of fact to be determined then the Court of Appeals has a very real interest in whether I've given consideration to this argument or that argument. Of course they might conclude that I could have reached this or that conclusion of facts, that I was clearly erroneous not to have taken into account this or that argument. In this particular situation the Court of Appeals is going to make up its own mind on the record whether I was right or wrong or whether an entirely different conclusion should have come and I hadn't thought of it. I don't know what that could be, but that's neither here nor there.

The strongest showing the Commission makes is that I should have taken testimony on the question of irreparable damage but for me to waste time doing that at this point would be, as far as I can see, in the last degree idiotic because the question needs to get decided and needs to get decided as fast as possible whether this regulation is valid or whether it isn't valid, not whether this particular plaintiff is injured by it or not.

I think there is enough in the record to support the temporary injunction, because assuming for the sake of argument there is not, it would be idiotic in the last degree to spend another week or two finding out whether there was or wasn't.

In the meantime delaying the decision of the ultimate question, should I have granted the motion for summary judgment or shouldn't I, if the rest of what the Commission says in its, I must say, extremely well

written brief, then I ought to be reversed and it ought to be done quick. If it isn't correct it really doesn't make any difference in the real world.

Well, the difference is minimal. I do think the order needs to be clarified and I use the term again that I don't think that is critical.

It seems to me the critical thing is plaintiffs in order to transact their business are required to transmit the premiums out of the country. Now 75 percent is what I get out of the oral argument. I may be wrong on that. I can't find it in the written record, but I have a very clear impression it was more or less the gist of the oral argument; out of the country to a clearing member of the foreign exchange in order that the option can be purchased and that is your requirement for business, and that is why the requirements would of the business seem to me to be incompatible with the regulation.

Now if it isn't then I'll be reversed and if it is I'll be affirmed. On the question of the stay, I can't remember whether I've ever given a stay pending appeal to the Court of Appeals. It seems to me that's the business of the Court of Appeals to decide whether or not there is an arguable question or if there is not.

MR. HECHT: Your Honor, I understand that with the Court of Appeals we checked before and they said we should bring it on here first and if you denied --

THE COURT: You have to bring it.

MR. HECHT: Right. So I had to, and I know that, and I explained that as far as the other point it's discretionary with you on the minimum financial requirements. I thought as a professional courtesy I should bring it to the Court's attention.

THE COURT: You have to. There is no question about it. Maybe I'm all wrong in my practice. My practice is not to grant stays. I've got to decide whether you're going to find merit in this. It seems to me they are much better qualified to decide that than I am.

Furthermore, another reason which may or may not apply to this case, but which probably does, once the Court of Appeals is asked to give a stay it's in a position to grant conditions and say what time you have to have your brief in, or whatever you want to do. I can't remember ever having done it, and I didn't see any indication doing it on this situation.

MR. SPINDEL: Your Honor, just two points.

First the terms of the clarification of the order, is your Honor going to amend his order to reflect what his thought were concerning the premiums being

transferred to London in terms of the critical aspect there?

THE COURT: I would prefer just to view this as a clarification and not waste the time it takes to make an amendment. At the moment if I leave it alone you can file your notice of appeal now and you're on your way. If I have to make an amendment, I have got a jury trial going, and it will take me time.

MR. SCHNEIDER: Could you just repeat the way you have clarified this?

THE COURT: Yes. What I meant by the order was what brought me to the conclusion that the regulation was unreasonable was that the plaintiffs in order to transact their business in the nature of things are required to transmit the premiums received. Now I figured that 75 percent of them -- I'm not sure if that was a correct figure -- out of the country to a clearing member of a foreign exchange in order that the option can be purchased.

My view is you have to transact, if you have to send 75 percent out of the country in order to do business, to be required to put up 90 percent is unreasonable.

MR. KAPLAN: 90 percent is a requirement under the rules.

THE COURT: Which is unreasonable. The commission clearly doesn't agree with me, and they may persuade the Court of Appeals that I am wrong.

MR. SPINDEL: Your Honor, one more point. This again is for purposes of the record to the extent the commission might wish to seek a stay of your Honor's preliminary injunction against the segregation requirement from the Court of Appeals while that appeal is going on. I'd like to move at this time for purposes of the record that the Court stay its order which granted the preliminary injunction.

THE COURT: That motion is denied.

MR. SPINDEL: Thank you.

MR. KAPLAN: Your Honor, logistically there is a time problem here, your Honor. It's my understanding that the Court of Appeals hears motions on Tuesdays and if we were to make a motion for the stay of the regulations they are according to the commission, the defendants herein, going into effect January 17th. Today is the 12th, your Honor, and we may have a time problem to get before the Second Circuit by next Tuesday, and the CFTC has issued press releases indicating --

THE COURT: What day of the week is the 17th?

MR. KAPLAN: The following Monday. Now it will take a great amount of effort to present the Court of Appeals with coherent and cohesive papers.

THE COURT: You can certainly do it by Tuesday. There is no problem about that.

MR. HECHT: The problem, your Honor, basically, we have the papers already drafted in our computer typewriter, so we could probably get them out by tomorrow. The problem is getting a hearing date because you have to bring it on by order to show cause because we'd have to bring it on before Monday which would really be tomorrow, which is Friday. That's the problem.

THE COURT: The papers must be all ready. You certainly ought to be able to have an order to show cause here tomorrow.

MR. HECHT: The problem is I am on trial before Judge Gagliardi and he wasn't too happy when I said I had to break at 4:15 to get here at 4:30.

We begin tomorrow at 9:45 and I should go to the 18th floor.

THE COURT: Someone else can go and present an order to show cause.

MR. HECHT: All right.

Then they have to set the date.

THE COURT: They're very fast up there.

MR. HECHT: Your Honor, what is the one point you were referring to your clarification of the order or was it anything else? You had mentioned there was one point you were considering.

THE COURT: That is all.

MR. HECHT: Thank you, your Honor.

THE COURT: Anything further, gentlemen?

MR. HECHT: Your Honor, Mr. Costikyan brought down frommy offices the papers that are already done. If we could submit them to you so you could mark motion denied on the papers so we could take it right up on a copy of mine.

MR. BLAU: Your Honor, I don't think we have a copy of those papers.

MR. HECHT: Those are my original papers, my notice of motion to request a stay.

THE COURT: Anything else?

MR. HECHT: Not that I can think of, your Honor. Thank you for making time for us.

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See Memo Endorsed

ENDORSED DENIAL OF MOTION

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

U. S. DISTRICT COURT
FILED
DEC 30 1976
S. D. OF N. Y.

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

MOTION FOR STAY PENDING APPEAL OR IN THE ALTERNATIVE, RECONSIDERATION OF CERTAIN PORTIONS OF THE COURT'S RULING OF DECEMBER 21, 1976

76 Civ 5124 (Knapp)

Upon the amended complaint and all the affidavits and other papers filed, and all the proceedings heretofore had herein, and the affidavit of Charles J. Hecht, Esq., with exhibits attached hereto, the plaintiffs move the Court for an order staying the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing certain portions of the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, pending the hearing and determining of plaintiffs' appeal to the United States Court of Appeals, Second Circuit from the order of this Court entered December , 1976, or in the alternative reconsideration of those portions of the Court's ruling dated December 21, 1976 relating to the rules

*Index No.* 5124 *Year* 1976

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, et. al,

Defendants.

ORDER TO SHOW CAUSE - MOTION - AFFIDAVIT OF CHARLES J. HECHT WITH EXHIBITS

76 Civ 5134 (Knapp)

PROPOSED ORDER TO SHOW CAUSE - MOTION
AFFIDAVIT OF CHARLES J. HECHT WITH EXHIBITS

CHARLES J. HECHT, Esquire
*Attorney for* Plaintiffs

SUITE 1760
60 EAST 42ND STREET
NEW YORK, N. Y. 10017
(212) 490-3232

*To:*

*Attorney(s) for*

*Service of a copy of the within* *is hereby admitted.*

*Dated:*

*Attorney(s) for*

*PLEASE TAKE NOTICE*

*Check Applicable Box*

☐ NOTICE OF ENTRY *that the within is a (certified) true copy of a entered in the office of the clerk of the within named court on* *19*

☐ NOTICE OF SETTLEMENT *that an Order of which the within is a true copy will be presented for settlement to the Hon.* *one of the judges of the within named Court, at* *on* *19* *, at* *M.*

*Dated:*

CHARLES J. HECHT, Esquire
*Attorney for*

SUITE 1760
60 EAST 42ND STREET
NEW YORK, N. Y. 10017

*To:*

Motion for a stay is denied for the reasons stated on the record in open court.

So ordered.

U.S.D.J.

Jan. 12, 1976

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
-------------------------------------------x

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

76 CIV. 5124

uk

Defendants.
-------------------------------------------x

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

NOTICE OF APPEAL

76 CIV. 2250

Plaintiffs,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, III, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.
-------------------------------------------x

Notice is hereby given that the NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, the Plaintiff above named, hereby appeals to the United States Court of Appeals for the Second Circuit from that part of the Order granting Defendants' motion for summary judgment entered in this action on the 3rd. day of January, 1977.

GUSRAE, GREENE & KAPLAN

By: Martin H Kaplan
A Member of the Firm
Attorneys for Plaintiff,
National Association of
Commodity Option Dealers,
67 Wall Street
New York, New York 10005
(212) 269-1400

Dated: January 13, 1977

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

---

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

---

NOTICE OF APPEAL

76 Civ 5124 (Knapp)

NOTICE IS HEREBY GIVEN that the plaintiffs above-named hereby appeal to the United States Circuit Court of Appeals for the Second Circuit, from the judgment of the District Court granting defendants' motion for summary judgment with respect to the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, except with respect to the segregation requirements set forth in Section 32.6 thereof.

Dated: New York, New York
January 13, 1977

Charles J. Hecht

Charles J. Hecht
Attorney for Plaintiffs
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

To: Commissioners
Commodity Futures
Trading Commission
One World Trade Center
Room 4774
New York, New York 10048

# DEFENDANTS' NOTICE OF APPEAL

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

filed USDC
SDNY
1/13/77

BRITISH AMERICAN COMMODITY OPTIONS CORP. ET AL.

Plaintiffs,

- against -

WILLIAM T. BAGLEY, ET AL.,

Defendants.

Civil Action No.
76 Civ. 5124 (WK)
(Consolidated)

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, ET AL.,

Plaintiffs,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, ET AL.,

Defendants.

## NOTICE OF APPEAL

PLEASE TAKE NOTICE that defendants hereby appeal To The Court of Appeals For The Second Circuit from the Order of this Court entered in the above-captioned action on January 4, 1977, insofar as that Order preliminarily enjoined the defendants from enforcing against any plaintiff the segregation provision contained in Section 32.6 of commodity option regulations adopted by the Commodity Futures Trading Commission in 41 Fed Reg. 51808 (November 24, 1976), and to that extent denied defendants' motion for summary judgment.

Frederic T. Spindel
FREDERIC T. SPINDEL
Associate General Counsel
Commodity Futures Trading Commission
2033 K Street N.W.
Washington D.C. 20581

Attorney for Defendants

Dated: January 12, 1977

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

--------------------------------------------x

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

76 CIV 5124

Defendants.

--------------------------------------------x

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY AND INTERNATIONAL COMMODITY OPTIONS, LTD.,

ORDER TO SHOW CAUSE

76 CIV. 2250

Plaintiffs,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, III, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.

--------------------------------------------x

Plaintiff, NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, moves for an Order staying implementation or enforcement of those regulations regarding commodity option dealers, as published in the Federal Register on November 24, 1976,

NOW, upon the affidavit of MARTIN H. KAPLAN, ESQ., sworn to the 13th day of January, 1977, and upon the affidavit of DAVID GREENE, ESQ., sworn to the 12th day of January, 1977, and the prior proceedings had herein, it is,

ORDERED, that the Defendants' show cause before this Court at Room , United States Courthouse, Foley Square, City, County and State of New York, on January , 1977 at o'clock that day, or as soon thereafter as counsel can be heard, why an Order should not be entered staying the Defendants', their officers, agents, servants, attorneys, employees, and all persons in active concert or participation with them, from implementing or enforcing those sections of the regulations published in the Federal Register on November 24, 1976, pending the determination of Plaintiff, NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS' appeal to this Court taken from that part of the Order handed down by the Honorable District Court Judge Whitman Knapp, which Order granted Defendants' motion for summary judgment; and it is further

ORDERED, that pending determination of this motion, the Defendants', their officers, agents, servants, attorneys, employees, and all persons in active concert or participation with them, are restrained from implementing or enforcing those regulations as published in the Federal Register on November 24, 1976 regulating commodity option dealers; and it is further

ORDERED, that service of a copy of this Order and supporting papers upon the Defendants' New York office on or before o'clock .M., on January , 1977, shall be good and sufficient service.

J.D.C.

Dated: New York, New York
January 13, 1977

# AFFIDAVIT OF MARTIN H. KAPLAN

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
------------------------------------------x

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.
------------------------------------------x

76 CIV 5124

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, III, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.
------------------------------------------x

AFFIDAVIT IN SUPPORT OF PLAINTIFF'S, NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, MOTION FOR A STAY PENDING DETERMINATION OF PLAINTIFF'S, NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, APPEAL

STATE OF NEW YORK )
:ss:
COUNTY OF NEW YORK )

MARTIN H. KAPLAN, being duly sworn, deposes and says:

1. I am a member of the firm of GUSRAE, GREENE & KAPLAN, ESQS., local counsel for the NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS ("NASCOD"), and am fully familiar with the prior proceedings had herein.

2. I submit this affidavit in support of Plaintiff, NASCOD's motion for a stay of implementation or enforcement of the regulations, regulating commodity option dealers as published in the Federal Register on November 24, 1976 ("the Regulations"), and the subject of the above captioned action.

3. As the attached affidavit of DAVID GREENE, sworn to the 12th day of January, 1977, filed with the District Court indicates, NASCOD joined Plaintiffs' BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD CARR & COMPANY, co-Plaintiffs herein, motion requesting the District Court to stay implementation and enforcement of the Regulations. The District Court denied said motion and suggested to counsel that the request for a stay be submitted to the Second Circuit.

4. Plaintiff, NASCOD's members will be irreparably harmed should the Regulations be effectuated and enforced.

5. Said irreparable harm includes, among other things:

(a) financial requirements which make the sale of commodity options financially unfeasible, i.e., one cannot survive and stay in business and meet the financial requirements.

(b) subjecting one selling commodity options, without registering as an Futures Commodity Merchant ("FCM"), to civil penalties and criminal liability;

(c) mandating, in effect, that the commodity option dealers serve as an insurer of the option until the expiration of the option;

(d) mandating disclosure requirements which, as compared to other businesses, are unduly harsh;

(e) leaving thousands of NASCOD's members' customers without a viable method of exercising the options they now hold because no commodity option dealers will survive in the United States under said Regulations.

6. It should be noted that numerous members of NASCOD have filed their FCM applications. The C.F.T.C. has failed to register or deny these applications.

WHEREFORE, Plaintiffs request the Court to grant its motion for a stay of the Regulations as published in the Federal Register on

November 24, 1976, thereby staying the Defendants from implementing or enforcing the Regulations, and for such other and further relief as the Court may deem just and proper.

Respectfully,

MARTIN H. KAPLAN
GUSRAE, GREENE & KAPLAN
Attorneys for Plaintiff,
National Association of
Commodity Option Dealers,
67 Wall Street
New York, New York 10005
(212) 269-1400

Sworn to before me this

13th day of January, 1977.

DAVID GREENE
Notary Public, State of New York
No. 03-1554650
Qualified in Bronx County
Commission Expires March 30, 1977

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

| | |
|---|---|
| BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,<br>Plaintiffs,<br>- against -<br>WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,<br>Defendants. | MOTION FOR STAY PENDING APPEAL<br>76 Civ 5124 (Knapp)<br>DOCKET NO. 77-6010 |

Upon the affidavit of Charles J. Hecht, Esq., and the exhibits thereto attached, the plaintiffs will move this Court at a motion term thereof to be held at the 27th Floor, United States Court House, Foley Square, New York, New York, on the 18th day of January, 1977, at 10:00 o'clock in the forenoon of that day, or as soon thereafter as counsel can be heard, for an order staying the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, pending the hearing and determination of an appeal to be taken to this Court by the plaintiffs from the order of the United States District Court for the Southern District of New York dated January 3, 1977 granting defendant's motion for summary judgment except with respect to the segregation requirements set forth in Section 32.6 of said regulations.

Since the said regulations will become effective on January 17, 1977 and as more fully set forth in the annexed affidavit and the exhibits thereto, irreparable harm will be done to the plaintiffs prior to the hearing of this motion, plaintiffs respectfully pray that this Court issue its Order staying any and all implementation of said regulations pending the hearing and determination of this motion.

Dated: January 13, 1977
New York, New York

Charles J. Hecht
Attorney for Plaintiffs
British American Commodity
Options Corp. and
Lloyd, Carr & Co.
60 East 42d Street - Suite 1760
New York, New York 10017
(212) 490-3232

Of Counsel: Haig Costikyan

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

AFFIDAVIT

76 Civ 5124 (Knapp)

CHARLES J. HECHT, being duly sworn, deposes and says:

1. I am the attorney for the plaintiffs in the above proceeding and am thoroughly familiar with all the facts and circumstances herein. I make this affidavit in support of the within motion by plaintiffs for an order staying the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, pending an appeal to this Court, from the order of the District Court dated January 3, 1977, granting defendants' motion for summary judgment except with respect to the segregation requirements set forth in Section 32.6 of said regulations as to which

the Court granted plaintiffs a preliminary injunction.

2. For the reasons set forth in my affidavit dated December 30, 1976, to the District Court, in support of a motion by defendant for an order staying such implementation or enforcement (copy annexed as Exhibit 1) which motion was not granted, it is submitted that such an order should be granted.

3. The District Court on January 12, 1977 denied the plaintiffs' motion for a stay pending appeal and also denied plaintiffs' application for a stay pending the hearing of this motion. This failure will, if allowed to stand, result in irreparable injury to defendant and its employees and customers in that the plaintiffs will be put out of business during the pendency of this appeal.

4. If their past practice is any guide, the defendants are prepared promptly on January 17, 1977 to virtually destroy the plaintiffs' business through adverse publicity (see Exhibits "A" and "B" to my affidavit of December 30, 1976), through advising the public against dealing with plaintiffs through their established "hot line" (see Exhibit "D" to my said affidavit) through the implementation of immediate steps to halt all operations of unregistered dealers.

5. Through their own inaction and their own uncertainty as to the proper interpretation of their own rules (for instance, the minimum financial requirements set forth in Reg. 1.17, see letter of Marvin Jackson dated December 1,

1976 and affidavit of Edward F. O'Brien dated January 11, 1977 annexed hereto as Exhibits 2 and 3 respectively), proper applications have been delayed and inadequately processed. Accordingly the industry is faced with a crisis not of its making whereby on January 17, 1977, the defendants are prepared to shut down its many members whose applications as futures commission merchants have not been processed. (See Exhibits 4 and 5 annexed).

6. In the interests of justice and in order to preserve the status quo it is respectfully requested that a stay as aforesaid be granted pending the hearing and determination of this motion.

7. Upon the return date of this motion, plaintiffs will move for a stay as aforesaid enjoining the defendants, their agents, officers, attorneys, employees, successors and assigns, and all persons in concert with them, from implementing or enforcing the regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, pending hearing and determination of the appeal.

8. Notice of Appeal by the plaintiffs from the said order of the District Court was filed today.

9. No previous application for the relief herein requested has been made, except for the motion before the District Court which has not been granted.

WHEREFORE it is respectfully requested that the motion be in all respects granted.

Charles J Hecht

Charles J. Hecht

Sworn to before me this
13th day of January, 1977

Haig Costikyan

Notary Public

HAIG COSTIKYAN
Notary Public, State of New York
No. 60-0775875 Qual. Westchester Co.
Commission Expires March, 30, 1977

EXHIBIT 2 TO AFFIDAVIT OF CHARLES J. HECHT

EXHIBIT 1

COMMODITY FUTURES TRADING COMMISSION
One World Trade Center, Suite 4747, New York, NY 10048

December 1, 1976

CERTIFIED MAIL - R.R.R.
Ms. Josephine Arcano, Vice President
Crown Colony Options, Ltd.
50 Broadway
New York, New York 10004

Dear Ms. Arcano:

A review of your firm's October 31, 1976 Statement of Financial Condition (Form 1-FR) recently submitted to our office discloses the following discrepancies:

1. The audit procedure used by our office in connection with commodity option dealers requires that the gains represented by the excess of the futures contract's market value (which underlines the option contract) over the option contracts striking price, be credited to the customer's equity account and the debit be shown as due from carrying brokers on the London Exchange, whichever is applicable. It appears from an examination of your firm's Form 1-FR that this procedure was not followed. As a consequence, the required 5 percent charge against working capital for the debit amount receivable and the required 5 percent charge for aggregate indebtedness for the amount credited were not taken.

   The audit performed on your firm's books and records as of August 31, 1976 disclosed that the unrealized gains of your customers on commodity options trading was approximately $175,000.00. Using this figure as a basis, the working capital shown on your firm's Form 1-FR would be reduced by about $35,000.00.

2. In a phone conversation with your accountant Mr. David Weinless, agreement was reached that receivables and current liabilities should be offset against each other by $128,625.00 thereby reducing charges against working capital by a significant amount. However, for your

information, we wish to bring to your attention that in order to make an entry on Schedule No. 1 item 7 for collateralized liabilities, a list must be attached to the Form 1-FR as described on the back of Schedule No. 1 in paragraph 2.

The above-mentioned matters are being brought to your attention so that, in the future, your firm can avoid making similar errors in preparing it's Form 1-FR, and also as an aid to your planning future capitalization of your firm.

Sincerely,

Marvin Jackson

Marvin Jackson, Acting Branch Chief
Office of Audit and Financial Review
Division of Trading and Markets
Eastern Region

EXHIBIT 4 TO AFFIDAVIT OF CHARLES J. HECHT

First New York Commodity Options, Ltd.
333 SYLVAN AVENUE – ENGLEWOOD CLIFFS, NEW JERSEY 07632
201-871-1160

Larry - This is a duplicate. Please advise...

January 5, 1977

Lawrence Burstein, Esq.
Zelby, Burstein, Bernstein & Hartman
One World Trade Center
Suite 2373
New York, N. Y.

Dear Larry:

Enclosed is a blank copy of our standard correspondent agreement.

I have been advised by a friend, Frank Genovese, President of Chartered Systems (another options dealer) that the CFTC has told him unequivocally that on the 17th of this month they intend to call various offices as well as visit them in attempt to find violations regarding the requirement for associated sales persons. If they are this intent on enforcing this, it effectively kills our business; at least temporarily. Frank advises me that he sent in associated sales persons' forms on September 2, and has not yet received any approval and has been told it will be at least a month more. Can we not apply to your courts to employ the rule of reason? If we operate in violation of the law, can they do anything more than ask us to cease and desist? Are these civil or criminal infractions? Is the liability limited only to corporations or can it filter to us as individuals?

Do you think it would be advisable for us to file a new FCM under a new corporation so that we have it available for future use (if we survive this idiocy)?

Please let me hear from you.

Cordially,

Jeffrey D. Wolfert
President

Enc.

EXHIBIT 5 TO AFFIDAVIT OF CHARLES J. HECHT

TEL (617) 482 7400
TELEX (TWX) 7103216791

ONDON COMMODITY OPTIONS
RECIOUS METALS

pma

PRECIOUS METALS ASSOCIATES
24 FEDERAL STREET • BOSTON, MASSACHUSETTS 02110

January 11, 1976

TO WHOM IT MAY CONCERN:

On August 23, 1976, Precious Metals Associates, Inc. filed application with the Commodity Futures Trading Commission for the Futures Commission Merchant designation. We filed this application at the time because we were considering dealing in domestic futures contracts. Our understanding, at the time, was that the minimum net working capital requirement was $10,000. Four months later, we were informed by letter that the minimum adjusted working capital requirement had been raised to $50,000 as of December 9; and that in light of this, we could not be given the FCM designation. We will be required to be registered as FCMs by January 17. We feel that the processing of our application has been unduly delayed. We have responded in a timely fashion to all requests for information made by the CFTC.

Stephen Gunnels
Stephen H. Gunnels
President

Carmine F. Mastrogiovanni
Witnessed this 11th Day January 1977
Carmine F. Mastrogiovanni, Notary
(My Commission Expires 1983)

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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No. 77-6010

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BRITISH AMERICAN COMMODITY OPTIONS
CORP., ET AL.,

Plaintiffs-Appellants-Cross Appellees,

v.

WILLIAM T. BAGLEY, Chairman of the Commodity
Futures Trading Commission, the COMMODITY
FUTURES TRADING COMMISSION, ET AL.,

Defendants-Appellees-Cross Appellants.

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## MEMORANDUM OF THE COMMODITY FUTURES TRADING COMMISSION AND ITS MEMBERS IN OPPOSITION TO PLAINTIFFS' MOTION FOR A "STAY" PENDING APPEAL

This case is before the Court on appeal from an Order and Judgment entered on January 4, 1977[1] by the District Court for the Southern District of New York (per Knapp, J.) in consolidated actions instituted by plaintiffs to obtain pre-enforcement review of commodity option regulations adopted by the Commodity Futures Trading Commission in 41 Fed. Reg. 51808 (November 24, 1976). A copy of these regulations is set forth in Appendix 2.[2]

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[1] A copy of that order is set forth in Appendix 1.

[2] The Commodity Futures Trading Commisison is an independent federal regulatory agency created, effective April 21, 1975, pursuant to the Commodity Futures Trading Commission Act of 1974, 88 Stat. 1389. That legislation extensively amended the Commodity Exchange Act, 7 U.S.C. §§1-17(b) (1970) by, among other things, bringing

(footnote continued)

Plaintiffs, which are nine firms engaged in the business of offering to the public so-called London commodity options,[3/] brought

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2/ (footnote continued)

within its scope virtually all previously unregulated commodities and vested the Commission with "exclusive jurisdiction" of "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery. . . ." Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. V, 1975). The challenged option regulations were adopted by the Commission pursuant to that section and §§4c(b) and 8a of the Act, as amended, 7 U.S.C. §§6c(b) and 12a. Section 4c(b) generally provides that no person shall offer or enter into any commodity option transaction "contrary to any . . . regulation of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . ." And under §8a(5) of the Act, the Commission is empowered to "promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this Act.

3/ A commodity option gives the purchaser the right, during a specified period of time, to buy ("call") and/or sell ("put") at a set price a specific futures contract or, in the case of an option on an actual commodity, a specific quantity of that commodity. In the case of so-called "London options" of the type offered by plaintiffs here, the option relates to futures contracts on commodities traded on the London commodity markets.

Plaintiff British American described the option transaction in the following manner. (See Memorandum in Support of Plaintiffs' Motion for a Declaratory Judgment and Preliminary Injunction, etc., dated December 9, 1976, pp. 2-8). After it obtains an order and receives funds from an option customer it will transmit the order to a "clearing agent" or "clearing broker" of the London exchange, which, in turn, will purchase the option on the London market from the option writer or "grantor" and then record the purchase on its books for British American's account. Thus, the clearing member with which British American deals acquires options for British American, through the exchange, solely in response to orders placed with it by British American; in turn, British American acts as an agent for its customers when it places those orders. A principal-to-principal relationship exists between London exchanges and the chain of transactions between the writer of an option in London and the firm such as British

(footnote continued)

the actions for declaratory and injunctive relief on their own behalf and not as representatives of any class.[4/] On November 17, 1976, plaintiffs moved for a preliminary injunction to enjoin enforcement of the regulations and on December 3, 1976, the defendants cross-moved for summary judgment.[5/]

The order of the district court, which was issued pursuant to its memorandum opinion of December 21, 1976,[6/] granted the Commission's motion for summary judgment as to all issues regarding the validity of the challenged regulations, except as to the provision contained in Section 32.6 of the regulations which requires that a commodity option dealer segregate in a separate account for the benefit of its customers 90% of the funds received from customers until such time as the option expires or is exercised and all obligations under the option have been fulfilled.

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3/ (footnote continued)

American which purchases the option for its customer in the United States. (Memorandum in Support of Defendants' Motion for Reconsideration, p. 4 and n. 5.).

[4/] Although plaintiffs moving papers purport to reflect the views concerning the Commission's option regulations of numerous members of the "commodity options industry," their claim being that the regulations are designed to and will destroy this industry, plaintiffs seek relief only as to themselves individually and there is no basis for their contention that other commodity options firms are unable to comply with the Commission's regulations.

[5/] The Commission itself and its five individual members were named as defendants in the actions. Unless the context otherwise requires all defendants shall hereinafter be referred to collectively as "the Commission".

[6/] A copy of the district court's opinion is set forth in Appendix 3.

With respect to this segregation provision the district court, in its order, preliminarily enjoined the Commission, during the pendency of the action, from enforcing that requirement against any plaintiff.

On January 21, 1977, the court below denied the Commission's motion for reconsideration of its decision with respect to the segregation requirement, and also denied plaintiffs' motion to enjoin, pending appeal, enforcement of the other regulations which the district court had held to be valid. Thereafter, both plaintiffs and the Commission on January 13, 1977, noticed their respective appeals from the district court's order.

Plaintiffs have now moved this Court, in effect, to enjoin the enforcement of the balance of the Commission's rules pending appellate review.[7/] The regulations for which plaintiffs seek an injunction (1) make it unlawful on and after January 17, 1977, for any person to accept money or property from an option customer as payment of the purchase price of a commodity option unless such person is registered with the Commission as a futures commission merchant (§32.3, 41 Fed. Reg. at 51814); (2) require individuals soliciting or accepting orders for commodity option transactions or supervising any person so engaged to register with the Commission as an associated person of a specified futures commission merchant by January 17, 1977 (§32.3, *id.* at 51814); (3) provide that registered futures commission merchants engaged in commodity option transactions maintain a minimum adjusted working capital of $50,000 or an

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[7/] Plaintiffs have styled their motion as one for a "stay" pending appeal. It is clear, however, that pursuant to Rule 8 of the Federal Rules of Appellate Procedure they are actually seeking an injunction against implementation of the option regulations as to them while they pursue an appeal in this Court.

amount computed in accordance with the provisions therein specified (§1.17, id.; (4) require that persons engaged in commodity option transactions provide prospective option customers with a summary disclosure statement setting forth general information relating to the option being offered, including a listing of the elements comprising the purchase price to be charged and a general description of all other costs incurred, and that any person, as part of the written confirmation of the execution of a transaction, furnish the option customer with particularized price information regarding the option within 24 hours after execution (§32.5, 41 Fed. Reg. at 51815; and (5) require each person engaged in the offer and sale of commodity options to maintain pertinent books and records, as therein specified, relating to the solicitation and the accounts of option customers (§32.7, id. at 51816).[8/]

This Memorandum is submitted in opposition to plaintiff's motion.

## ARGUMENT

### THE PLAINTIFFS HAVE NOT SATISFIED THE HEAVY BURDEN IMPOSED UPON PERSONS SEEKING AN INJUNCTION PENDING APPELLATE REVIEW.

In order to justify the granting of an injunction or stay pending appeal, the plaintiffs must make:

1) A strong showing that they are likely to prevail on the merits of their appeal;

2) A showing that absent an injunction, they will suffer irreparable injury;

3) A showing that the issuance of an injunction will not substantially harm other persons interested in the proceedings; and

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[8/] These regulations became effective on December 9, 1976 except the registration and minimum financial requirements which are to become effective on January 17, 1977.

4) A showing that there will be no harm to the public interest if an injunction is granted. 9/

As stated by the Supreme Court, "[a] stay is not a matter of right, even if irreparable injury might otherwise result to the appellant. . . . The propriety of its issue depends upon the circumstance of a particular case." *Virginian Ry. Co.* v. *United States*, 272 U.S. 658, 673-674 (1926). The moving party bears an especially heavy burden in obtaining such relief where the public interest, as represented by a government agency, is involved.

In this case the motion for an injunction should be denied; plaintiffs have not shown that any of the above criteria are met, much less demonstrated that all of them exist in this case, which is the burden they must sustain.

1. Plaintiffs have failed to set forth any error of fact or law by the court below which demonstrates a likelihood of success on the merits of their appeal. The district court carefully considered, and emphatically rejected (Op. 15-18) plaintiffs various contentions 10/ that the regulations were invalid because (1) the Commission allegedly failed to comply with provisions of the Administrative Procedure Act requiring public comment on proposed rules and provided that good cause must be

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9/ *Eastern Airlines, Inc.* v. *Civil Aeronautics Board*, 261 F.2d 830 (2d Cir. 1958) and *Virginia Petroleum Jobbers Association* v. *Federal Power Commission*, 259 F.2d 921, 925-926 (D.C. Cir. 1958); *Associated Securities Corp.* v. *Securities and Exchange Commission*, 383 F.2d 773, 774-775 (10th Cir. 1960); *Airport Commission* v. *Civil Aeronautics Board*, 296 F.2d 95, 96 (4th Cir. 1961); *Cf. Atlantic Richfield Company* v. *Federal Power Commission*, 398 F. Supp. 1 (S.D. Tex. 1975); *Roe* v. *Ferguson*, 389 F. Supp. 393 (S.D. Ohio 1974); *Stop H-3 Association* v. *Volpe*, 353 F. Supp. 14 (Haw. 1972).

10/ See affidavit for Charles Hecht (¶9, December 30, 1976).

stated to put into effect regulations within less than 30 days after adoption (5 U.S.C. 553(d)); (2) the Commission violated Section 15 of the Act which requires the Commission to consider the anticompetitive effect of its regulations; and (3) the registration, minimum financial and disclosure requirements were unreasonable and thus arbitrary and capricious. The district court's findings and conclusions on these issues were fully supported by the record and all pertinent judicial authorities. As to the procedural requirements of the Administrative Procedure Act the court found, as clearly revealed from the history of the rule-making processes (See appendix 4, pp. 10-20) that the Commission had solicited broad public participation by inviting written comments from interested persons on its earlier rule proposals and concluded that the Commission was not required to hold an oral hearing or solicit further public comments merely because the rules as finally adopted contained some substantive changes from their earlier proposals. THis ruling was fully in accord with decisions of the Supreme Court and various courts of appeals. United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973); California Citizens Band Association, Inc. v. United States, 375 F.2d 43 (9th Cir. 1967). See also South Terminal Corporation v. Environmental Protection Agency, 504 F.2d 646, 658-659 (1st Cir. 1974); International Harvestor Company v. Ruckelshaus, 155 U.S. App. 411, 478 F.2d 615 (1973); Logansport Broadcasting Corporation v. United States, 210 F.2d 24 (D.C.C. 1954). The court below also found that the Commission had indeed stated "good cause" to make certain provisions of the regulations effective within 15 days after adoption (See appendix 4, pp. 56-57). In any event the fact that the Commission has taken no action to enforce those provisions during the 30 day period from adoption renders the question of compliance as to that section of the Administrative Procedure Act moot. Cf. Lewis-Mota v. Secretary of Labor, 469 F.2d 478 (2d Cir. 1972) and Borg Johnson Electronic, Inc. v. Christenberry, 169 F. Supp. 746 (S.D.N.Y. 1959). Similarly the court's conclusion that the regulations satisfied the requirement in Section 15 of the Act that the Commission consider the policy underlying the anti-trust laws and "endeavor to take the least anti-competitive means of achieving the . . . purposes [of the Commodity Exchange Act]. . . ." was supported by the legislative history of that Section (See Appendix 4, pp. 27-29 and Supreme Court authority). United States v. Interstate Commerce Commission, 396 U.S. 491, 513-514 (1970). Moreover the fact that persons who deal with public investors should be required to provide examination information to make an informed investment judgment and to register with a federal agency and maintain sufficient net capital to protect investors from losses due to insolvency or sharp practices is hardly a novel or unreasonable regulatory concept, particularly for the commodity options area which has had a history of fraudulent activities, insolvencies and other abuses (Appendix 5, p. 8, n. 10). Plaintiffs have advanced no new facts or cited any judicial decisions upon which a reviewing court might reasonably rule otherwise on these issues.

2. Nor have plaintiffs shown any significant--let alone irreparable--injury either to themselves or to others if the rules should remain in effect during pendency of this appeal. On three occasions, the district court held that plaintiffs would not be irreparably injured by complying with the Commission's registration, recordkeeping and dis-

closure requirements and nothing in their moving papers reflects that circumstances have changed. Compliance with these regulations will, at most, subject plaintiffs to nominal expenses which may easily be passed on to their customers. The disclosure and recordkeeping requirements have been in effect since December 9 and none of the plaintiffs' claim that they have been or are about to be forced out of business as a result. And as plaintiffs' own papers reflect, their claim that the minimum financial requirement is impossible for any dealer to meet is based on a misinterpretation of those provisions. In any event, mere financial injuries, however substantial, even if suffered, are insufficient to warrant an injunction against administrative action:

> "Serious as [an] injury may be, it is not of controlling importance as primary consideration must be given to the statutory intent to protect investors." 11/

3. The public interest in enforcing these regulations clearly outweighs the interests of plaintiffs. The public interest would not be served, and in fact would be severely impaired, by enjoining implementation of these rules, designed to protect members of the investing public, which the district court found to be valid. In issuing a preliminary injunction against enforcement of the segregation requirements, the court below expressly relied upon the fact that there was

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11/ Associated Securities Corporation v. Securities and Exchange Commission, 283 F.2d 773 at 775 (10th Cir. 1960). See also Allen v. Grand Central Aircraft Company, 347 U.S. 535 (1954), Yakus v. United States, 321 U.S. 414 (1943), Scripps-Howard Radio v. Federal Communications Commission, 316 U.S. 4 (1942), Myers v. Bethlehem Shipbuilding Corp., 303 U.S. 41 (1938).

"a wide panoply of regulations already and about to be in effect" providing customer protections (Appendix 3 at 15). Plaintiffs would now have this Court strip their public customer if any of these protections while they leisurely pursue an unmeritorious appeal. Such a result should not be permitted.

None of the contentions advanced by plaintiffs support its application for an injunction pending appeal. Plaintiffs profess concern for the interests of their customers in urging this Court to enjoin regulations designed for customer protection (Hecht Aff., December 30, 1976, ¶12). Their claim lacks credibility, however, since they have vigorously resisted having to comply with disclosure requirements and minimum financial requirements.

Plaintiffs also assert that the Commission is seeking through its regulations to destroy the options industry by instituting a customer "hot line". Plaintiffs seem to take personally the Commission's attempts generally to warn the public about fraudulent activities in the commodity option industry and its attempts to alert the public how to discern sharp practices (Hecht Aff. December 30, 1976, ¶¶10, 11; Forma Aff. December 30, 1976, ¶¶2 and 4).[12/] But the Commission's effort to fight fraud through public education surely provides no basis upon which this Court may enter an injunction pending appeal.

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[12/] Plaintiffs also ask that their customers be subjected to unnecessary risks merely to assist the plaintiffs to compete on more favorable terms with firms that offer other forms of investment (Hecht Aff. December 30, 1976, ¶9).

Nor is it relevant to the issues at bar that in view of the district court's injunction regarding segregation the Commission has stated that it will have to consider other approaches to investor protection--including, possibly, banning commodity option trading. Counsel's suggestion (Hecht Aff. December 30, 1976, ¶2) that the Commission's recognition of this duty is somehow an "insult to the integrity of . . . the entire judicial system," reflects an insensitivity to the proper relationship between the courts and administrative agencies concerning regulatory matters. While the courts have a duty to assure that agencies act in accordance with the law, so long as it does so the agency is free to exercise its discretion within the area of regulatory authority entrusted to it by Congress.[13/]

In its Memorandum Opinion of December 21, 1976, the district court rejected plaintiffs' attack upon the minimum financial requirements imposed under the option regulations. That decision was based, in part, upon the court's conclusion that the plaintiffs' "arguments against the minimum financial requirements were grounded upon a misunderstanding of the Commission's regulation." Counsel now asserts (Hecht Aff. ¶4) that the Commission misinformed the district court concerning the proper interpretation of the rules. He emphasizes an inconsistency between the interpretation given to the court and an interpretation of that regulation reflected in a letter that was earlier written by a Commission employee. The letter counsel relies upon was written shortly after the

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[13/] *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402 (1971); *United States* v. *Pierce Auto Freight Lines*, 327 U.S. 515 (1946); *General Transportation Co. of Southwest* v. *United States*, 449 F. 2d 846 (5th Cir., 1971); *Automotive Parts & Accessories Assn.* v. *Bogel*, 407 F. 2d 330 (D.C. Cir. 1968), cited with approval, *National Nutritional Foods Assn.* v. *Weinberger*, 512 F. 2d 688 (2d Cir. 1975); *Mulry* v. *Driver*, 366 F. 2d 544 (9th Cir. 1966).

adoption of the Commission's option rules, however, and before the interpretative position presented to this Court had been formulated. Accordingly, that letter is not "typical" of the current position taken, as counsel erroneously asserts (id. ¶5); rather, the Commission's staff has since been following the interpretation of which this Court was advised.[14/] Moreover, there is absolutely no factual basis for plaintiffs bald statement (Hecht Aff. of January 12, 1977 ¶5) that the Commission has delayed the processing of applications because of confusion as to the net capital requirements and are prepared on January 17 to "shut down on any option dealers whose applications for registration have not been processed. All applications for registration which were filed prior to December 27, 1976, have been acted upon and various option dealers have been registered including Crown Colony Options, Ltd. (compare Exhibit 2 to Hecht Aff. of December 30, 1976) and Precious Metals Associates (compare Exhibit 4 to Hecht Aff. of January 12, 1976) Other option dealers, such as plaintiff Bristol Options filed applications only within the last two weeks and processing has not been completed while others, such as plaintiff Lloyd, Carr & Co. have not applied at all. In announcing adoption on November 24, 1976, of the registration provisions, the Commission advised affected persons to promptly file their applications as processing would take at least 30 days. Thus, the fact that some dealers chose to wait until after December 27 to file, and cannot be registered by January 17 is not due to any impropriety by the Commission.

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[14/] See Affidavit of Edward F. O'Brien attached as Exhibit 3A to Hecht Affidavit dated January 12, 1977, and Exhibit 6.

Plaintiffs also reiterate their claim (Hecht Aff. December 30, 1976,¶8) that under Regulation 1.19 option dealers who register as futures commission merchants would be "prohibit[ed] from trading in commodity options. . . ." As the Commission showed in the Court below (Appendix 4, p. 48), however, that regulation merely prohibits futures commission merchants from assuming financial responsibility for an option, but leaves them free to buy options as agents for their customers. Since it appears from the record (see Memorandum in Support of Plaintiffs' Motion for a Declaratory Judgment and Preliminary Injunction, etc., dated December 9, 1976, pp. 2-8) and from Mr. Hecht's affidavit itself (December 30, 1976, ¶6) that plaintiff's business is conducted solely on an agency basis, they can hardly claim that this provision subjects them to any present risk or inconvenience.

## CONCLUSION

For the foregoing reasons, plaintiffs' motion for an injunction pending appeal should be denied.

Respectfully submitted,

Frederic T. Spindel
FREDERIC T. SPINDEL
Associate General Counsel

CHARLES E. HORD III
Attorney

VIRGINIA F. CRISMAN
Attorney

Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D. C. 20581
(202) 254-[illegible]

January 14, 1977

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
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BRITISH AMERICAN COMMODITY OPTIONS CORP.,
and LLOYD CARR & CO.,
Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

76 CIV 5124

Defendants.
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NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTION INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY AND INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs,

REPLY AFFIDAVIT

DOCKET # 77-6010

76 CIV 2250

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, III, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.
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STATE OF NEW YORK )
:ss:
COUNTY OF NEW YORK )

MARTIN H.KAPLAN, being duly sworn, deposes and says:

1. I am a member of the Law Firm of GUSRAE, GREENE & KAPLAN, local counsel for the NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, ("NASCOD"), and am fully familiar with the prior proceedings had herein.

2. Your deponent submits this affidavit in support of Plaintiffs' motion for an interim stay and stay pending appeal enjoining the enforcement and implementation of the regulations as published in the Federal Register on November 24, 1976 ("the Regulations") governing the sale of London Commodity Options, the enforcement and implementation of which is presently scheduled for January 17, 1977. (a copy of the Regulations is attached hereto as Exhibit "A").

3. This action was commenced in November 1976 seeking both declaratory and injunctive relief with respect to the Regulations.

4. On December 21, 1976, the Honorable District Court Judge Whitman Knapp issued an opinion in this case (a copy of which is attached hereto as Exhibit "B"), enjoining the segregation provisions of the Regulations (section 32.6 thereof) as well as granting Defendants motion for summary judgment as to all the other causes of action contain in the Plaintiffs' complaint.

5. On December 30, 1976, Plaintiffs BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD CARR & COMPANY brought on by an order to show cause, a motion to stay the implementation and enforcement by the Defendants of the minimum financial requirements (Section 1.17) disclosure provision (32.5) and registration provisions (Section 1.19 and Regulations 32.3) of the Regulations. All other Plaintiffs subsequently joined in this request. The Defendants' much publicized motion for reconsideration was not filed till the late afternoon of January 10, 1977 resulting in the postponment of the hearing of the Plaintiffs' motion for a stay until January 12, 1977. (a copy of Judge Knapp's order of January 3, 1977 is attached hereto as Exhibit "C", as well as a copy of the transcript of the hearing of Plaintiffs' motion for a stay heard on January 12, 1977, attached hereto as Exhibit "D").

6. On Thursday, January 13, 1977, Plaintiffs filed with the Clerk of this Court both a Notice of Appeal and a Motion requesting a stay pending appeal of the enforcement of the Regulations. The regulations, if there is no stay, will go into effect January 17, 1977. Copies of the Notice of Appeal and Motion papers were served on the Defendants on Thursday, January 13, 1977, at the Defendants' office located at One World Trade Center, New York, New York.

7. With respect to Plaintiffs' request for a temporary stay and/or injunction until January 18, 1977, the Clerk advised us that

Defendants were to file by 10:00 A.M. January 14, 1977. The Defendants' failed to file their papers until the evening of January 14, 1977, at approximately 5:30 P.M. preventing the Court from considering our request for an interim stay.

8. Upon information and belief, the Defendants herein, without regard to the necessity for a decision and without regard to the Court, failed to file answering papers with the Court until 5:30 P.M. on Friday, January 14, 1977, although told by the Clerk of the Court to file answering papers by 10:00 A.M. January 14, 1977. The Defendants' failure to file answering papers made it impossible for the Court to reach a determination on Plaintiffs' request for an interim stay pending the oral argument on January 18, 1977 of Plaintiffs' motion for a stay pending appeal of Judge Knapp's order regarding the Regulations governing the sale of commodity options.

9. Upon information and belief, at or about 5:45 P.M. on Friday, January 14, 1977, Defendants served their "Memorandum In Opposition to Plaintiffs' Motion for a Stay Pending Appeal" on the Plaintiffs' attorneys' office.

10. Defendants' memorandum in opposition to Plaintiffs' motion argues that "the Plaintiffs' have not satisfied the heavy burden imposed upon persons seeking an injunction pending appellate review". More particularly, the Defendants' submit that the Plaintiffs' in order to succeed, must:

(a) make a showing that absent an injunction they will suffer irreparable harm;

(b) make a strong showing that they are likely to prevail on the merits of their appeal;

(c) make a showing that the issuance of an injunction will not substantially harm other persons interested in the proceedings; and

(d) make a showing that there will be no harm to the public interest if an injunction is granted.

11. Defendants would have the Court believe that the Plaintiffs herein have failed to satisfy their burden of making a strong showing that they are likely to prevail on the merits of their appeal. Defendants' contention is without foundation. The moving papers herein, as well as the entire record clearly indicates, that the Plaintiffs' are likely to prevail on appeal. Both Judge Knapp's opinion dated December 21, 1976 (attached hereto as Exhibit "B") and his order signed on January 3, 1977 (attached hereto as Exhibit "C") enjoining the segregation provisions of the Regulations, (Section 32.6 of the Regulations) inherently demonstrates that there is a strong likelihood that the Plaintiffs will prevail on appeal. Moreover, the voluminuous papers filed by the Plaintiffs, representing the record within this action, indicate as well as brief numerous legal theories,which legal theories gave rise to the conclusion that the Plaintiffs will be successful in their appeal based on the merits of this action. Included among other theories within those papers indicating the likelihood of Plaintiffs' success are:

(a) the Defendants' adoption of the Regulations are arbitrary, capricious and an abuse of discretion in violation of 5 U.S.C. 706;

(b) the failure of the Defendants to satisfy the notice requirements of Section 553 of the Administrative Procedure Act by failing to publish the Regulations 30 days prior to their effective date;

(c) the violation of 7 U.S.C. 19 by the Defendants which section mandates the Defendants' usage of the least anti-competitive means in regulating the commodity options business.

(d) the enabling statute fails to prescribe the parameters of the Defendants' powers, i.e., the agency is given overbroad power to determine whom it will register and to whom it will give exemptions from registration, without the statute providing any legislative guidelines. (Moreover, the statute fails to set forth any limitations of time within which applications for registration must be processed for Future Commission Merchants ("FCM") or to mandate in the alternative automatic registration upon the agency's failure to act on applications for registration as FCM's within a prescribed period of time). This point was completely overlooked by the District Court below.

12. Additionally, there are constitutional grounds which clearly indicate Plaintiffs' probable chance of success on this appeal on the merits. These constitutional grounds include, among other things:

(a) violation of the Plaintiffs' right to privacy, as incorporated within the Fourth Amendment of the United States Constitution in that the Plaintiffs will be required to disclose their markups, fees, costs and profits;

(b) violation of the Plaintiffs' Fifth Amendment due process rights in that the Regulations deprive the Plaintiffs of life, liberty and property without due process of law; and

(c) violation of the Constitution in that the Regulations delegate the legislative function to the Defendants without setting forth standards to guide the Defendants as is noted in Judge Knapp's opinion, attached hereto as Exhibit "B", Page 14.

13. As additional indication of the probability of Plaintiffs' success, attached hereto as Exhibit "E" is the "Commodity Law" column of David C. Buxbaum, Esq., which appeared in the New York Law Journal on January 12, 1977 on Page 1, wherein Mr. Buxbaum states that Judge Knapp erred in his reading of 7 U.S.C. 19.

14. The Plaintiffs' probability of success is patent and the Plaintiffs' have met their burden of proving their chances of success upon the merits.

15. The Plaintiffs have, as a matter of record, clearly established that they will suffer irreparable harm should the Regulations not be stayed by the Court.

16. The Regulations are, according to the Defendants, effectiv and enforceable as of January 17, 1977. Said enforcement of the Regulations on January 17, 1977 will irreparably harm the Plaintiffs in that, among other things:

(a) the Regulations incorporate financial requirements which make the sale of commodity options financially unfeasable, i.e., the dealer will not be able to meet these minimum financial requirements and stay in business;

(b) the Regulations subject the Plaintiffs to civil and criminal penalties, including fines and imprisonment;

(c) the Regulations mandate disclosure requirements which a unduly harsh compared to other businesses of which many are regulated by the Defendants;

(d) it will put thousands of those individuals who now hold commodity options in a position where, should these regulations be effectuated and enforced by the Defendants, those individuals will not have dealers to exercise their options as all such dealers will be put out of business;

(e) place the Plaintiffs herein in a position where their continuance in operation will subject them to administrative actions by other governmental agencies (e.g. Securities and Exchange Commission) by virtue of the Defendants' failure to register the Plaintiffs by the effective date of the Regulations, i.e., January 17, 1977;

(f) many wholesalers of commodity options in the United States have announced that they will only sell options to those dealers who are registered pursuant to the Regulations as FCM's. Thus, should the

Regulations be enforced,many of the Plaintiffs herein will not be able to obtain a supply of London commodity options from their wholesalers as upon the enforcement of the Regulations, Plaintiffs will not have been registered as FCM's and will effectively be put out of business because of the Defendants'inaction.

17. Defendants would have the Court believe that the Plaintiffs must show that the issuance of a stay by the Court cannot be granted without a showing that no substantial harm will result to other persons interested in the proceeding. Even assuming that Defendants' contention is correct, Defendants have failed to indicate or illustrate to the Court any harm that will result to other persons interested in the proceedings should the Court grant a stay.

18. The Defendants contend that the public interest necessitates the Court's denying the Plaintiffs' motion for a stay. Yet, the Defendants cannot substantiate their contention regarding public interest with other than mere conclusion and misrepresentations. There are adequat regulations, promulgated by the Defendants, as well as statutes to protect the public interest without enforcement of those Regulations which are the subject of this law suit. Substantially, all of the Plaintiffs herein are already subject to Defendants' jurisdiction and regulation as Commodity Trading Advisors.

19. Defendants submit to the Court (Page 10 of Defendants' memorandum in opposition to Plaintiffs' motion for a stay pending appeal) that Plaintiffs herein have no concern for the interest of its customers

in that the Plaintiffs have virorously resisted having to comply with the disclosure requirements to minimum financial requirements. Should Plaintiffs give up their right to due process and other constitutional and statutory rights merely because the Defendants have capriciously decided to draft regulations which have the effect of destroying that which it is attempting to regulate? The Regulations clearly have no relation to protecting the public and/or regulating the commodity option industry.

20. Clearly, the Defendants have failed to establish that the regulations, if not enforced and effectuated, as promulgated and adopted by the Defendants, will adversely affect the public interest.

21. The Plaintiffs herein are not, as the Defendants have previously suggested (see interview with Vice Chairman of the C.F.T.C., Rainbolt, as it appeared in the Commodities Magazine of November 1976, attached hereto as Exhibit "F") "Crooks and Bunco Artists", but upstanding businesmen who seek the regulatory body charged with regulating their industry to satisfy its legal duty without violating other statutes and the U. S. Constitution. It breeds disrespect for the law when those charged with the responsibility of upholding the law themselves violate the law.

22. The Defendants have argued before the District Court that the Commodity Options Industry is frought with individuals who seek to defraud the public. The Defendants have repeatedly cited the Goldstein Samuels & J. S. Love cases (Securities and Exchange Commission v. Goldstei Samuelson Inc., 73 Civ 472 (C.D. Cal Act 29, 1973), Commodity Futures Trading Commission v. J. S. Love and Associates Options, Ltd., 76 Civ 928 (SDNY 1976), in support of their position. Both of these cases are easily distinguished from the instant action. In the Goldstein-Samuelson and J. S. Love cases, the Defendants were selling naked options to the public (a naked option is an option where there is no underlying futures contract). In this action, none of the Plaintiffs are selling naked options to the public, but are selling options where each and every opiton has an underlying futures contract supporting it as well as each option having been registered with either the London International Commodity Clearing House (ICCH ) or London Metal Exchange (LME).

23. The urgency and absolute necessity of the Court's granting a stay and /or enjoining of the enforcement of the Regulations by the Defendants pending appeal is indicated by the conduct which the Defendants are about to engage in.

24. Howard Schneider, general counsel for the Defendants herein has informed co-counsel in this action, Charles J. Hecht, Esq., that the Defendants have prepared a press release which shall be distributed to the media on January 17, 1977, listing those commodity option dealers

who have registered and been accepted by the Defendants and those who have not registered and/or whose registration has not been accepted by the Defendants. (the above is more fully described in the Hecht affidavit of January 14, 1977).

25. It becomes increasingly evident that the Defendants are attempting to accomplish that which they could not do in the Courts and administrative forum by waging a media compaign against the commodity options industry, i.e., the Plaintiffs herein, thereby encouraging the public not to do business with the Plaintiffs, even though the issues in this action presently before the Court have not been decided,as well as destroying Plaintiffs'reputation without due process.

26. Defendants have become so mezmerized by their own false publicity regarding the Plaintiffs herein that they have blatently and recklessly misrepresented facts to this Court as well as to the District Court below. In Defendants' memorandum in opposition to Plaintiffs' motion for a stay pending appeal,at Pg 12, during their discussions of the registrationprovisions of the Regulations state "while other such as Plaintiff Lloyd, Carr & Co. have not applied at all". Said representation is patently false and is indicative of the Defendants' reckless conduct in their attempt to destroy the Plaintiffs' businesses. Plaintiff Lloyd Carr & Company has within its possession correspondence with the Defendant indicating that Plaintiff Lloyd Carr & Co. filed its application for

registration with the Defendants as of October 1, 1976, that the Defendants sent back Plaintiff Lloyd Carr & Co.'s application for registration without a word as to the basis for said return of the application by the Defendants to Plaintiff Lloyd Carr & Co. Copies of the application, as time stamped by the Defendants, shall be presented to the Court following its arrival in New York from Boston.

27. Because of the nature of the Defendants' conduct and posture throughout this involved litagation whereby the Defendants have used the media to misrepresent the status of the litigation between the parties herein, misrepresent the conduct of the Plaintiffs; misrepresent the ethical and moral makeup of the Plaintiffs; misrepresent an entire industry, the Plaintiffs respectfully request that should the Court grant a stay pending appeal the Court incorporate within its stay and/or injunction a provision enjoining the Defendants from issuing press releases relating to this litigation, the proposed regulations or the Defendants' proposed actions, pending a determination by this Court of this appeal.

WHEREFORE, on behalf of the Plaintiffs herein, it is respectfully requested that the Court issue an order staying the enforcement of the Regulations by the Defendants, their agents, employees and servants pending determination of the Plaintiffs' appeal as well as issue an order enjoining the Defendants, their agents, employees and servants, from issuing press releases relating to this litigation, the proposed Regulations, and/or the Plaintiffs herein pending determination of the Appeal taken from the Honorable Judge Knapp's order of January 3, 1977.

Respectfully,

MARTIN H. KAPLAN
GUSRAE, GREENE & KAPLAN
Attorneys for Plaintiff
National Association of
Commodity Option Dealers
67 Wall Street
New York, New York 10005
(212) 269-1400

Sworn to before me this

16th day of January, 1977.

DAVID GREENE
Notary Public, State of New York
No. 03-1554650
Qualified in Bronx County
Commission Expires March 30, 197

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

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BRITISH AMERICAN COMMODITY OPTIONS CORP., et. al,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, et. al,

Defendants.

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AFFIDAVIT

Docket No. 77-6010

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, et. al,

Plaintiffs,

- against -

COMMODITY FUTURES TRADING COMMISSION, et. al,

Defendants.

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State of New York )
) SS.
County of New York )

Charles J. Hecht, being duly sworn, deposes and says:

1. I am the attorney for the plaintiffs in the case entitled British American Commodity Options Corp. and Lloyd, Carr & Co., Plaintiffs, against William T. Bagley, et. al. I make this affidavit in support of plaintiffs' request for a temporary restraining order pending the hearing on plaintiffs' motion for a stay pending argument on Tuesday, January 18, 1977, of plaintiffs' motion for a stay pending the hearing and determination of the appeal of certain portions of Judge

Knapp's order and judgment dated January 3, 1977.

2. It is deponent's understanding that this Court scheduled a hearing in accordance with plaintiffs' Motion for a Stay Pending Appeal but took no action with respect to plaintiffs' request staying any and all implementation of said regulations pending the hearing and determination of this motion on January 18, 1977.

3. At approximately 5:15 p.m., on January 14, 1977, deponent was advised by Michael Volpe of Commodity News Service, which advice was subsequently confirmed by Howard Schneider, General Counsel of the Commodity Futures Trading Commission as follows:

(a) The defendants voted late Thursday night not to extend the January 17, 1977 deadline for registration of commodity option dealers as futures commission merchants and all sales employees as associated persons.

(b) The defendants discussed what enforcement actions they will take against persons not yet registered. In response to a specific question, Mr. Schneider advised deponent that this would include companies (FCMs) and sales employees (APs) who had filed but whose applications had not yet been processed.

(c) That on the morning of January 17, 1977, the CFTC intends to release a list with respect to all commodity options dealers which will state as follows:

1. Who has been registered;

2. Who will be registered;

3. Who the staff has recommended for registration, even though they may have filed in what the staff has determined to be an untimely manner;

4. Who the staff will not recommend.

3. It is self-evident that the companies and/or persons employed by them who are listed under the heading of companies and persons who the staff will not recommend will have their reputations and businesses irreparably harmed. As to plaintiff British American Commodity Options Corp. it filed its FCM application on December 31, 1976 and the associated persons applications of its sales employees were filed immediately thereafter in Chicago. Judge Knapp's decision was first made available at 6:00 p.m. on December 21, 1976 and the order and judgment was not signed until January 3, 1977. Mr. Schneider indicated that it was his position that British American's filings were not timely and they would be placed in the the fourth category listed above.

4. Deponent has been advised by James Carr, the President of Lloyd, Carr & Co. that his firm filed its FCM application in October, 1976 and has the application been returned by the defendants for certain amendments and that he intends to refile on January 17, 1977.

5. Furthermore, as shown in Exhibits 4 and 5 to the motion, there appears to be numerous other companies and associated persons who will be adversely affected.

6. The defendants are well aware of the scheduled hearings on January 18, 1977 and are taking the position that the immediate publication of this release is "in the public interest." Mr. Schneider's position is that the

plaintiffs' suit herein is "frivolous."

7. This suit is obviously not frivolous, as shown by Judge Knapp's opinion granting a preliminary injunction against the defendants from implementing or enforcing certain portions of the regulations. However, an analysis of Judge Knapp's opinion by David C. Buxbaum, in the New York Law Journal on January 12, 1977 indicates that in his opinion, certain portions of Judge Knapp's rulings which were against the plaintiffs herein are clearly wrong and on appeal, might readily be reversed. A copy of this article is annexed hereto.

8. Under these circumstances, it is deponent's belief that this is the ultimate insult to the integrity of our entire judicial system in general and to this Court in particular. The defendants' tactics represent the ultimate in denial of due process and the improper use of the media to destroy the business reputations of innocent parties.

9. It was only through the courtesies extended by Allen Wax of the New York office of the Commodity News Service who knew I was on trial before Judge Gagliardi in another matter, that deponent first became aware of the Commission's tactics on Friday evening. At no time did either opposing counsel or anyone else associated with the defendants have the courtesy of calling deponent to advise him of the actions being taken by the defendants. The defendants knew on January 12, 1977 that the plaintiffs were requesting a temporary stay under Rule 8 of the Rules of

Appellate Procedure because the first motion term available to hear plaintiffs' request pending a hearing and determination on appeal under said rule is Tuesday, January 18, 1977.

10. As a professional courtesy, deponent is personally serving a copy of this affidavit on a staff attorney this evening and has advised the staff attorney that we will appear at 9 a.m., January 17, 1977, before this Court for a temporary stay pending the hearing scheduled on January 18, 1977 and a determination of said motion.

WHEREFORE, deponent respectfully requests that the Court immediately grant plaintiffs' request for a temporary stay and such other and further relief as to this Court is just and proper under the circumstances.

Charles J. Hecht

Charles J. Hecht

Sworn to before me this
14th day of January, 1977

Haig Costikyan

Notary Public

HAIG COSTIKYAN
Notary Public, State of New York
No. 60-0775875 Qual. Westchester Co.
Commission Expires March, 30, 1977

# modities Law

By David C. Buxbaum

*The author of this column, which is a regular feature of the Law Journal, is a member of the law offices of David C. Buxbaum, P.C.*

## Regulation of Commodity Option Transactions — Recent Litigation

The rules regulating commodity options on future contracts issued by the Commodity Futures Trading Commission went into effect on Dec. 9, 1976. There have, however, been numerous complaints about the new regulations and certain action has been taken in an attempt to bring about judicial modification of these regulations. The leading case thus far is *British American Commodity Options Corporation, et al. v. William T. Bagley, et al*, 76 Civ. 5124, which was decided by Judge Whitman Knapp of the United States District Court for the Southern District of New York on Dec. 21, 1976.

### The Amended Complaint

The amended complaint in the *British American* case alleged numerous grounds to restrain and enjoin the Commodity Futures Trading Commission from implementing or enforcing the options regulations. In addition, the plaintiffs sought a declaratory judgment as to the constitutionality and legality of a substantial portion of such regulations.

*Continued on back page, column 1*

# Commodities Law

*Continued from page 1, column 1*

The complaint alleged that the regulations were not published in accordance with the provisions of the United States Code, because there was no opportunity to submit comments to these regulations, and the regulations failed to comply with the requirement that there be a specific finding in order to invoke the "good cause" exception to the thirty-day notice provision.

Furthermore, the plaintiffs alleged, the minimum financial requirements established by the regulations were arbitrary, capricious, an abuse of discretion, and punitive and have no relationship to the method of operations of plaintiffs or other retail dealers in London Commodity Options, or to the protection of customers, and deprive the plaintiffs of their business without due process of law. Furthermore, said requirements are in excess of the statutory authority and jurisdiction, are anticompetitive and in direct violation of 7 USC Section 19, and the minimum financial requirements established will cause immediate and irreparable harm to the plaintiff and others.

The disclosure requirements were alleged to be arbitrary and capricious, an abuse of discretion, and punitive. In addition, numerous provisions of the regulations were said to be required only by purveyors of commodity options and not of those purveying other futures contracts. The disclosure provisions, in addition, were allegedly not the least anticompetitive means of enforcing the act.

There are also allegations that the book and record keeping requirements are capricious and an abuse of discretion. The registration requirements were also alleged to be arbitrary, capricious and an abuse of discretion and in violation of Section 2(B) in that they deprive plaintiffs of their property without due process and fail to establish any standards for granting exemptions to registration.

### The Decision

#### A. Potential Invalidity of the Entire Statute

The opinion in the *British American* case suggests that it is possible that an entire section of the statute granting the Commission authority to regulate options may be invalid, for failure of Congress to provide any standards to guide the Commission. The opinion noted: "Whether or not such failure to provide standards could be said to invalidate this portion of the legislation such failure should at least be deemed to impose on the Commission the obligation of taking particular pains to ensure that its rulemaking will not be arbitrary and capricious." (Opinion, pages 14 and 15). Therefore, the court preliminarily enjoined the Commission from enforcing the regulations requiring segregation. The court noted that the plaintiffs were threatened with irreparable injury in that since their business requires them to forward at least 75 percent of the premiums they receive for options from their customers to London, ". . . they could not long remain in business if required to segregate in the United States an amount equal to 90 percent [as required by CFTC Rules] of such funds." (Opinion, p. 15). The court in granting the injunction noted that the ". . . plaintiffs have a reasonable likelihood of success in establishing that defendants acted arbitrarily and capriciously in imposing segregation requirements — at least as applicable to option dealers, who, like plaintiffs, act only as agents." (Opinion, p. 14).

#### B. Anticompetitive Aspects

The opinion held that it was sufficient if the Commission stated that it did consider the anticompetitive aspects of various alternatives and that the Commission was not required to adopt the least anticompetitive means of enforcing its rules. The opinion interpreted 7 USC Section 19 (Supp. V. 1975) to mean that consideration by the Commission is sufficient despite the fact that the statute is quoted to the effect that the Commission must ". . . endeavor to take the least anticompetitive means of achieving the objectives of this act. . . ." It would clearly seem both from a reading of the statute and the historical background to the statute that the Commission must do more than merely consider the anticompetitive impact of various alternatives. It must make a conscious effort to take the least anticompetitive means in achieving the objective of the act. Thus, it would seem that the opinion with regard to this section of the act on page 18 is clearly wrong and on appeal might readily be reversed. The decision granted the defendant Commission's motion for summary judgment in all respects except with regard to the segregation rules, enforcement of which was enjoined.

### C. Commission's Varied Approaches to Options

The opinion discusses the numerous approaches that the Commission has proposed and taken with regard to regulation of options, since it has been granted authority to regulate options on commodity futures.[1] Changes have been rather dramatic and varied.

The Commission, being a new organization, has had to establish numerous subsidiary regulations in order to meet its obligations under the amended Commodity Exchange Act. The manner in which the option program has been handled, however, has been far from salutary. Not only has the Commission proposed numerous diverse approaches, but the only approach it finally put into effect was actually promulgated, contrary to the opinion, without an opportunity for full public hearings. The fact that a substantial element in the Commission's regulations have now been, in essence, set aside, bespeaks of the lack of care with which the Commission has undertaken its work in this field.

### Commission's Reaction

The Commission's reaction to this decision was surprising. The Commission moved to have the court reconsider its decision and apparently is moving to appeal the decision of Judge Knapp. In the interim the CFTC has threatened that ". . . unless there is a timely and favorable resolution of the Commission's motion to reconsider or, alternatively, a timely and favorable resolution of an appeal from the Court's order, the Commission feels that the public interest will compel it to reexamine certain fundamental issues relative to its earlier decision, including, but not limited to, the right to suspend commodity option trading in its entirety, limiting the offer of London options to clearing members of the London Commodity Exchange/ICCH complex, increasing financial requirements to more substantial levels, or other action designed to limit the risk of customers being unable to obtain the benefits of their bargain."

Just how the segregation rule protects a customer from obtaining the benefit of its bargain is never fully explained by the Commission. In fact, from all its rules and regulations in the option field, and its numerous conflicting approaches that have been taken in the past year, one has the distinct impression that the Commission is not fully acquainted with what commodity options are all about. The rather impetuous reaction to a negative court decision is most unfortunate.

### Conclusion

The Commission, burdened with substantial responsibilities in a most important field, and still young and learning, while undertaking important responsibility, must develop a more judicious and patient reaction to judicial decisions. A proper reaction to Judge Knapp's decision might be that the Commission will reexamine the option rules with the object of meeting some of the other objections that have been raised to the rules, rather than insisting on its own initial, and judicially determined, wrongful approach. Putting legitimate entrepreneurs out of business is not regulation, but confiscation, which apparently is a sensitivity the new Commission has failed to acquire.

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(1) See, Buxbaum, Commodities Law, / NYLJ, November 10, 1976, p. 1; Buxbaum, Commodities Law, NYLJ, July 14, 197 , p. 1.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

---------------------------------------------x

BRITISH AMERICAN COMMODITY OPTIONS CORP.,
and LLOYD CARR & CO.,

Plaintiffs,

- against -

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

76 CIV 5124

Defendants.

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NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTION INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY AND INTERNATIONAL COMMODITY OPTIONS, LTD.,

REPLY AFFIDAVIT

DOCKET # 77-6010

76 CIV 2250

Plaintiffs,

- against -

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, III, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, JR., Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.

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STATE OF NEW YORK )
) SS.:
COUNTY OF NEW YORK )

CHARLES J. HECHT, being duly sworn, deposes and says:

1. I am the attorney for the two original plaintiffs in 76 Civ 5124 and am fully familiar with the prior proceedings had herein, including all papers presently filed with the Court with respect to plaintiffs' request for a temporary stay pending the hearing and determination of its motion pursuant to Rule 8 for a stay pending appeal to be heard by this Court on Tuesday, January 18, 1977.

2. This reply affidavit is submitted in support of the plaintiffs' motion for a stay pending appeal enjoining the enforcement and implementation of certain regulations, as published in the Federal Register on November 24, 1976 (the "regulations") governing the sale of London commodity options; to wit, the registration provisions set forth in Section 32.3 of the regulations, the disclosure requirements set forth in Section 32.5 of the regulations and the minimum financial requirements set forth in Reg. 1.17, which is made applicable to dealers in London commodity options by the regulations. A copy of the regulations, opinion of Judge Knapp, as modified on January 12, 1977 and other related papers have already been furnished to the Court.

3. Since the very inception of this litigation, the plaintiffs herein have advised the courts of the immediate and irreparable harm which the foregoing specific regulations

will impose on the plaintiffs herein, as well as certain other retail dealers of London commodity options. In this connection, deponent advised this Court on Monday morning, January 17, 1977 that the defendants intended to refuse to grant registration to all dealers not yet registered. Furthermore, it is deponent's understanding that the defendants advised the Court that in its press release, it would only list the FCMs who were registered. However, as has been the plaintiffs' sad experience in dealing with this agency, their press conference held at approximately 11:30 a.m., to which deponent listened via an extension phone in the New York Regional Office of the defendants, shows that they did exactly what the plaintiffs said they would do in their papers filed with this Court on Monday morning. In view of the pending motion to be heard on January 18, 1977, which was not even mentioned at this press conference, it is deponent's view that the holding of such press conference was improper. In addition, only members of the press were permitted to ask questions after the press conference and once again, they encouraged the use of their "hot line."

4. At that press conference, Vice Chairman Rainbolt of the CFTC stated that there were 15 firms which were not yet registered and it is the defendant's position that anyone not registered as at 12:01 a.m. on January 17, 1977 must cease doing business as a dealer in London commodity options immediately. Not only did Vice Chairman Rainbolt name the firms, but with respect to British American Commodity

Options Corp. ("British American"), he discussed a copy of an administrative complaint by that agency against the plaintiff British American with the press and all other persons in attendance at this press conference. Neither British American nor its counsel has been served with a copy of this complaint, although certain of its allegations were disseminated to the general public: (i) fraud in the inducement; (ii) violation of the registration requirements of the Act; and (iii) a particular person who has a controlling interest, has been enjoined by the Securities and Exchange Commission and has had various other problems with that agency.

5. Vice Chairman Rainbolt also stated that as to all firms not yet registered, that there was a "definite threat of criminal sanctions and that they would refer this to the Justice Department, and under their statutes they could impose substantial fines." Furthermore, Mr. Schneider stated that such firms are subject to private suits if they still do business after January 17, 1977.

6. This poses the threat of immediate and irreparable harm to both of the named plaintiffs in 76 Civ 5124, as well as other companies and employees who are in a similar situation. With respect to the plaintiff British American, Vice Chairman Rainbolt's comments are clearly improper as they represent an administrative reversal of an opinion of a United States District Court Judge. Attached hereto as Exhibit "A" is a copy of the full opinion in the case entitled CFTC v.

British American Commodity Options Corp. (S.D.N.Y. 1976) CCH Fed.Comm.Fut.L.Rep. ¶20,224 which denied the Commission's request for a preliminary injunction by way of a directed verdict, and thus, British American, pursuant to a court determination after an evidentiary hearing, is permitted to operate until the conclusion of the administrative process. In that case, the court specifically found that there was no evidence that British American was mistreating or misleading its customers or the general public and does no apparent harm to the public interest by being allowed to do business (at p. 21,215).

7. With respect to the plaintiff Lloyd, Carr & Co. ("Lloyd, Carr"), the statement that they have never applied ~~this~~ is an outright lie. Attached hereto as Exhibit "B" is the affidavit of James Carr sworn to on January 16, 1977, with exhibits, which shown, as reflected by the defendants' own time stamp, that its application as a futures commission merchant was received and filed with the defendants at 1:07 p.m. on October 1, 1976 as well as the cancelled check of Lloyd, Carr in the amount of $200 representing the filing fee. As shown in the affidavit of James Carr, that company is not registered as a FCM due solely to the fault of employees of the defendants herein.

8. The plaintiffs throughout this litigation have contended that the registration provisions of Section 32.3 are unconstitutional and in violation of various provisions of 5 U.S.C. §706 because there are no standards, including the time within which the staff must act on an FCM or

associated person application, for determining who will be granted registration or given an exemption. At page 14 of Judge Knapp's opinion he states that the Act does not provide any standards, and the failure to provide any standards may invalidate all of the legislation authorizing regulation of commodity options. Thus, as to Section 32.3 of the regulations, by mere inaction the staff has effectively and arbitrarily determined, without any notice or hearing, the future of both Lloyd, Carr and British American. This clearly violates due process of law as guaranteed by the Fifth Amendment. The defendants' press conference of January 17, 1977, as anticipated in my affidavit of January 14, 1977 and hereinabove described, is the best evidence of the immediate and irreparable harm without any due process. The defendants' position is all the more surprising in view of Judge Gagliardi's comment in footnote 6 to the Appendix at p. 21,218 that certain portions of the registration provisions (i.e., the FCM registration provisions) do not provide a time limit for hearing and thus may be violative of due process.

9. Accordingly, under such circumstances and in the interest of justice it would be totally inequitable to permit the registration provisions set forth in Section 32.3 to go into effect and the only effective remedy of the plaintiffs is for this Court to grant a stay and/or an injunction pending the appeal of this portion of the regulations as to which Judge Knapp granted summary judgment.

10. Deponent was also advised by Bristol Options, as to whom the defendants have stated that their application was filed "only within the last two weeks", is in error because Don Jackler, President of Bristol Option, informed deponent on Sunday, January 16, 1977 that Bristol originally filed its application as an FCM in the beginning of December, 1976. Similarly, their comments with respect to Precious Metals Associates are also factually in error. Mr. Gunnels of Precious Metals Associates called by office on Monday and advised my office that although they were registered as an FCM, the Commission had sent them a telegram advising them that they could not trade options because the Commission believes that they do not have $50,000 in net capital which belief Mr. Gunnels vigorously disputes. On Thursday, January 13, 1977, Precious Metals Associates filed it updated, unaudited financials with the New York Regional Office. Accordingly, the defendants' comments at the press conference that this company does not have capital of $50,000 and, thus, cannot transact any commodity option transactions is wrong.

11. In its efforts in opposition to plaintiffs' motion the defendants are making irresponsible statements in an attempt to justify its position that they and the regulations, as to which summary judgment was granted, are reasonable and proper.

cfW

12. Accordingly, unless the defendants are enjoined from implementing and enforcing the regulations relating to

the registration provisions pending the hearing and determination of this appeal, the two named plaintiffs herein, plus at least 14 other companies, will be put out of business and/or are being overtly threatened with severe civil and criminal proceedings under the Act. There is not one scintilla of evidence that permitting either of these plaintiffs to operate during such period is harmful in any way to its customers or the general public. See CFTC v. British American Commodity Options Corp (supra at p. 21.215).

13. As already pointed out in plaintiffs' Memoranda filed with the District Court, as well as the Buxbaum article which has heretofore been supplied to this Court, Section 19 of the Commodity Exchange Act of 1974, as amended (the "Act"), provides as follows:

> "The Commission shall take into consideration the public interests to be protected by the anti-trust laws and endeavor to take the least anti-competitive means of achieving the objectives of this chapter . . . in issuing any order or adopting any Commission rule or regulation . . ."

14. It has been plaintiffs' position throughout this litigation that this statute requires the defendants to take affirmative steps to implement any regulations with respect to the anti-trust laws. Judge Knapp took the position which position was proposed by the defendants, that all that Section 19 requires is that the Commission consider the anti-competitive aspects and since the Commission considered such aspects, they were free to adopt the most anti-competitive regulations. Section 19 of the Act is applicable to

all of the rules and regulations promulgated and published on November 24, 1976 and plaintiffs believe that there is a strong likelihood that this Court will reverse Judge Knapp on that issue. In the one published article commenting on this decision, the author fully agrees with the plaintiffs' position. See Buxbaum article in New York Law Journal dated January 12, 1977, a copy of which has heretofore been furnished to the Court.

15. Furthermore, even if there was not a specific statutory direction with respect to the anti-trust laws, the case law has uniformly helds that a regulatory agency is under an affirmative obligation to adopt regulations which are not inconsistent with the anti-trust laws. Pillai v. CAB, 485 F.2d 1018 (D.C. Cir. 1973); Overseas Mediacorp v. McNamara, 385 F.2d 308 (D.C. Cir. 1967); and Hecht v. Pro-Football, Inc., 444 F.2d 931 (D.C. Cir. 1971), cert. denied, 404 U.S. 1047, 92 S.Ct. 701, 30 L.Ed.2d 736. The underlying legislative history to the adoption of Section 19 fully supports plaintiffs' position that Judge Knapp erred in his interpretation of 7 U.S.C. §19. See 1974 U.S. Code Cong.Adm.News, pp. 5847 and 5863.

16. As to the minimum financial requirements set forth in Reg. 1.17 they advised the District Court of one interpretation on December 10, 1976, which misrepresentation was the basis for Judge Knapp's ruling adverse to the plaintiffs, while taking a diametrically opposite position in practice. When this was brought to the Court's attention, they filed

an affidavit rescinding one of their prior interpretations. Every time a question is raised they come up with a new interpretation of this regulation. Accordingly, until the defendants understand and publish how they are going to finally interpret Reg. 1.17 they must be stayed and/or enjoined because not to do so would permit them to arbitrarily put people out of business.

17. The ultimate proof of the necessity for a stay and/or injunction is Vice Chairman Rainbolt's statement at the press conference that "even before the appeal is decided they may consider abolishing all commodity options." In short, this Court has for all practical purposes no alternative but to grant the relief requested by the plaintiffs.

18. British American clears through Genora Commodities and deponent has just been advised at 5:36 p.m. January 17, 1977, that the staff will recommend enforcement to the Commission against anyone who clears for British American, thus preventing British American from purchasing or selling options for its customers.

WHEREFORE, deponent respectfully requests that the plaintiffs' motion be in all respects granted and for such other and further relief as this Court deems proper under the circumstances.

Charles J. Hecht

Charles J. Hecht

Sworn to before me this
17th day of January, 1977.

Haig Costikyan

Notary Public

HAIG COSTIKYAN
Notary Public, State of New York
No. 60-0775075 Qual. Westchester Co.
Commission Expires March, 30, 1977

EXHIBIT "A" TO AFFIDAVIT

## [¶ 20,224] CFTC v. British American Commodity Options Corp.

United States District Court, Southern District of New York. 76 Civ. 3247. October 20, 1976. Opinion in full text.

Preliminary Injunctions—Equity Discretion of Court—Not Precluded by Statute.—The equity discretion of the court in issuing preliminary injunctions has not been precluded from matters arising from violations of the Commodity Exchange Act and may be invoked by the court in weighing the competing interests of the Commodity Futures Trading Commission in enforcing the Act and the party named in the motion for an injunction.

See ¶ 11,575, "Liabilities—Prohibitions" division.

Preliminary Injunctions—Requirements—"A Proper Showing"—Securities and Exchange Commission Case Law Applicable.—The statutory requirement for a preliminary injunction brought under Sec. 6c of the Commodity Exchange Act is that "a proper showing" be made by the CFTC. In this action, the CFTC showed that a London options dealer was functioning as a commodity trading advisor after having been denied registration as such. The court stated that the requirements for a preliminary injunction brought by an agency such as the CFTC do not follow the same guidelines as those for private litigants. Securities and Exchange Commission case law on the subject was considered applicable. It was noted that a showing must be made that the alleged wrong may be repeated in the future without injunctive relief and also that the public interest in enjoining the defendant outweighs the defendant's private interest in continuing its business.

See ¶ 10,250, "Liabilities—Prohibitions" division.

Commodity Trading Advisors—Denial of Registration Without Hearing—Enjoining Continuance of Business Pending Hearing—Basis for "Good Cause" Insufficient.—If automatic registration as a commodity trading advisor is the accepted course of action for the Commodity Futures Trading Commission under Sec. 4n(2) of the Commodity Exchange Act and a denial of registration pending a hearing is based on bare SEC consent orders as "other good cause", then the continuation of a London options dealer in business without registration is not sufficient grounds for a preliminary injunction. A mere showing by the CFTC that the dealer was functioning as a commodity trading advisor in the course of its business of options trading was deemed insufficient grounds, given the structure of the registration process.

See ¶ 7625 and 7925, "Registration" division.

Commodity Trading Advisors—Registration—Denial Prior to Hearing for "Other Good Cause"—Use Narrowed.—A denial of registration for a trading advisor prior to a hearing that is based on a bare consent order obtained by the SEC which is proffered as "other good cause" in accordance with Sec. 8a(2)(E), is an expansive use of the "other good cause" standard which undercuts the intent of the Act. The court further explained that the intent of the Act with regard to the registration of trading advisors was to register them unless they are deemed to be unfit after notice and an opportunity to be heard. Specific grounds are mentioned in Sec. 8a(2) for denials without a hearing, namely a failure to meet minimum financial standards or a felony conviction. Considering the harshness of the result of injunctive relief here, the basis for the "other good cause" grounds, and the equity discretion of the court, it decided that the grant of a preliminary injunction here was too harsh and not warranted by an overriding public interest.

See ¶ 7625 and 7925, "Registration" division.

Jurisdiction—Doctrine of Primary Jurisdiction—Pendency of Administrative Proceeding—No Effect on Preliminary Injunction.—The pendency of an administrative proceeding in no way causes the doctrine of primary jurisdiction to interfere with the district court considering a request from the Commodity Futures Trading Commission for a preliminary injunction against the party to the administrative proceeding. Section 6c of the Commodity Exchange Act specifically allows the CFTC to seek injunctions regardless of the pendency of administrative proceedings. The court also noted that

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the purpose of the preliminary injuntion is only to stop the defendant from doing business until the outcome of the administrative proceeding.

See ¶ 10,250, "Liabilities—Prohibitions" division.

**Preliminary Injunctions—Procedural Review by Court—CFTC Compliance With Commodity Exchange Act Necessary.**—In order for the district court to grant a request for a preliminary injunction under Sec. 6c of the Commodity Exchange Act, the court must review the actions taken by the Commodity Futures Trading Commission. The purpose of the review is to ensure that the CFTC has complied with the provisions of the Act before considering the merits of the injunction. Here, the court found that the CFTC had initiated its action of denying registration within the thirty day period established by Sec. 4n(2) for that purpose and the Commission was found to have acted within the provisions of Sec. 8a(2) in denying registration.

See ¶ 7625, and 7925, "Registration" division, and ¶ 11,575, "Liabilities—Prohibitions" division.

Charles Harris, Esq. and Leslie Blau, Esq., Attorney for Plaintiff, Commodity Futures Trading Commission.

Charles Hecht, Esq., Attorney for Defendant, New York, New York.

Gusrae, Greene & Kaplan, Attorney for Defendant, Bert Gusrae, Esq., Of Counsel, New York, New York.

GAGLIARDI, D. J.: Plaintiff Commodity Futures Trading Commission ("CFTC") moves by order to show cause for a preliminary injunction, pursuant to Rule 65, Fed. R. Civ. P., to enjoin defendant British American Commodity Options Corp. ("British American") from making use of the mails or any means or instrumentality of interstate commerce in violation of Section 4m of the Commodity Exchange Act, as amended ("the Act"). 7 U. S. C. § 6m.[1] In a decision read into the record on October 6, 1976 (Appendix A), the court denied defendant's cross-motion to dismiss the action pursuant to Rule 12(b)(1), (2) and (6), Fed. R. Civ. P., for lack of jurisdiction and for the failure of the complaint to state a claim upon which relief can be granted and, pursuant to Rule 65, Fed. R. Civ. P., ordered an evidentiary hearing on the preliminary injunction motion which was held on the same day. After plaintiff CFTC rested its case, defendant British American moved for a directed verdict pursuant to Rule 50 Fed. R. Civ. P. The court reserved decision on the motion. For the reasons stated herein, the court directs a verdict for the defendant and denies plaintiff's motion for a preliminary injunction.

At the evidentiary hearing plaintiff introduced evidence solely on the issue of whether the defendant qualified as a "commodity trading advisor" under Section 2(a) of the Act, 7 U. S. C. § 2,[2] and therefore was required to register with the CFTC under Section 4m of the Act, *supra*. This evidence was adduced through eight witnesses whose testimony was limited solely to showing that employees of British American gave advice over the phone on commodity options as an investment vehicle and mailed explanatory pamphlets to customers and potential customers.

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[1] 7 U. S. C. § 6m. Same: use of mails or other means or instrumentalities of interstate commerce.

It shall be unlawful for any commodity trading advisor or commodity pool operator, unless registered under this chapter, to make use of the mails or any means or instrumentality of interstate commerce in connection with his business as such commodity trading advisor or commodity pool operator: *Provided*, That the provisions of this section shall not apply to any commodity trading advisor who, during the course of the preceding twelve months, has not furnished commodity trading advice to more than fifteen persons and who does not hold himself out generally to the public as a commodity trading advisor.

[2] 7 U. S. C. § 2 . . . The term "commodity trading advisor" shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities; but does not include (i) any bank or trust company, (ii) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation including their employees, (v) any contract market, and (vi) such other persons not within the intent of this definition as the Commission may specified by rule, regulation, or order:, . . .

The only other relevant testimony introduced at the hearing, in the form of exhibits, was the "commodity trading advisor" registration application of British American filed in March 1976 and other exhibits relating to the status of the administrative law proceeding.

The CFTC has brought this preliminary injunction motion pursuant to the authority granted in Section 6c of the Act, 7 U. S. C. § 13a-1, which provides that:

> Whenever it shall appear to the [CFTC] that any . . . person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule, regulation, or order thereunder, . . . the [CFTC] may bring an action in the proper district court of the United States . . . to enjoin such act or practice, or to enforce compliance with this chapter, or any rule, regulation or order thereunder . . . . Upon a proper showing, a permanent or temporary injunction . . . shall be granted without bond.

In all material respects this provision is identical to the injunctive provision in the Securities Act of 1933, § 20(b), 15 U. S. C. § 77t(b) and in the Securities Exchange Act of 1934, § 21(e), 15 U. S. C. § 78u(e). Accordingly, case law developed under the injunctive provisions of the securities laws is pertinent to the case at bar. *CFTC v. J. S. Love & Associates Options, Ltd.*, ¶ 20,198, CCH COMM. FUT. L. REP. at 21,106-07 (S. D. N. Y. 1976).

CFTC enforcement actions seeking injunctive relief, like Securities and Exchange Commission ("SEC") actions, are not governed by the criteria that apply in private injunction suits. *SEC v. Management Dynamics, Inc.*, 515 F. 2d 801, 808 (2d Cir. 1975). Proof of irreparable injury or the inadequacy of other remedies as in a private injunction suit is not required. *Id.*; III L. Loss, Securities Regulation 1979 (1961, Supp. 1969). However, the issuance of an injunction is always subject to the principles of equitable discretion. *Hecht Co. v. Bowles*, 321 U. S. 321, 328-30 (1944); *SEC v. Texas Gulf Sulphur*, 312 F. Supp. 77, 87 (S. D. N. Y. 1970), *aff'd in part and rev'd in part*, 446 F. 2d 1301 (2d Cir.), *cert. denied*, 404 U. S. 1005 (1971). Section 6c of the Act requires that "a proper showing" be made before a preliminary injunction "shall be granted". Such language affords no sufficient basis for concluding that Congress meant special weight to be given the CFTC's decision to institute suit. *See SEC v. Frank*, 388 F. 2d 486, 491 (2d Cir. 1968). As stated by the Second Circuit Court of Appeals in *SEC v. Management Dynamics*, 515 F. 2d at 808 (citations omitted):

> We scarcely mean to imply that judges are free to set to one side all notions of fairness because it is the SEC, rather than a private litigant, which has stepped into court. . . . "[I]n deciding whether to grant injunctive relief, a district court is called upon to assess all those considerations of fairness that have been the traditional concern of equity courts." *See CFTC v. J. S. Love Assoc., supra* at 21,107.

If Congress had intended that the courts refrain from exercising their sound discretion in equity jurisdiction, it would have had to say so in unequivocal language in the Act. *See Hecht Co. v. Bowles, supra* at 327-29; *SEC v. Frank, supra* at 491. In deciding whether to grant a preliminary injunction in this case:

> The only question presented at this stage of the proceedings, namely an application for a preliminary injunction in advance of a trial upon the merits, [before the administrative law judge] is whether a violation . . . has been so clearly established that defendants are, in effect, to be found at fault without awaiting the development of all the facts upon a trial. *SEC v. Capital Gains Research Bureau, Inc.*, 306 F. 2d 606, 608 (2d Cir. 1962) (en banc), *rev'd on other grounds*, 375 U. S. 180, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963); *see SEC v. Management Dynamics, supra* at 807 n. 1.

While the facts presented at the hearing in this case indicate, for the limited purpose of this preliminary injunction motion, that British American qualifies as a "commodity trading advisor",[8] this conclusion alone is not enough to grant CFTC's preliminary injunction. Under Section 4m of the Act, if British American is a "commodity trading advisor" it must register with the CFTC to do business. However, British American did file a registration application in March 1976. CFTC asserts that it rejected British American's application on April 16, 1976; that Section 4m

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[8] British American contests that it is a "commodity trading advisor" and filed its registration application without conceding that the CFTC had jurisdiction over its activities. *See* Appendix A at 2. This issue must be finally determined in the administrative proceeding and the finding in the case at bar in no way prejudges the merits of British American's claim.

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of the Act prohibits doing business while unregistered; and that, therefore, this court must grant a preliminary injunction prohibiting British American from doing business.

CFTC's argument ignores the equity discretion of this court, and its logic falls upon a closer examination of the Act and CFTC's actions against British American. The Act generally provides for automatic registration of applicants with the CFTC upon the expiration of a thirty-day period after an application is filed. Section 4n(2) of the Act, 7 U. S. C. § 6n(2);[4] *see* Appendix A at 5. Even in those situations where the CFTC decides that registration should be denied, in almost all cases such denial can only come after an opportunity for a hearing. *See* Section 4(n)7 and 8a(2) of the Act, 7 U. S. C. §§ 6(n)(7)[5] & 12a(2).[6] In one situation, where a person is subject to an outstanding order under the Act denying trading privileges or revoking registration, registration can be denied without ever providing for a hearing. Section 4n(6) of the Act, 7 U. S. C. § 6n(6).[7] Finally, under three special situations, the Act allows registration to be denied prior to a final determination in the administrative proceeding.[8] Section 8a(2)(C), *supra* ("Provided, That pending final determination under clause (B) or (C), registration shall not be granted"); *see* Appendix A at 6-7. The first two special situations, conceded by the CFTC not to be at issue in the case at bar, are when minimum financial requirements are not met, Section 8a(2)(C) of the Act, *supra*, and when a person with certain specified interests in the registering corporation has been convicted of a felony or has committed other specified acts. Section 8a(2)(B)(i) of the Act, *supra.*

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[4] 7 U. S. C. § 6n (2) Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission, or within such shorter period of time as the Commission may determine.

[5] 7 U. S. C. § 6n (7) The Commission after hearing may by order deny registration, revoke or suspend the registration of any commodity trading advisor or commodity pool operator if the Commission finds that such denial, revocation, or suspension is in the public interest and that—

(A) the operations of such person disrupt or tend to disrupt orderly marketing conditions, or cause or tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities;

(B) such commodity trading advisor or commodity pool operator, or any partner, officer, director, person performing similar function or controlling person thereof—

(i) has within ten years of the issuance of such order been convicted of any felony or misdemeanor involving the purchase or sale of any commodity or security, or arising out of any conduct or practice of such commodity trading advisor or commodity pool operator or affiliated person as a commodity trading advisor or commodity pool operator; or

(ii) at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from acting as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or as an affiliated person or employee of any of the foregoing, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of commodities or securities; or

[6] 7 U. S. C. § 12a. Registration of commission merchants and brokers; fees; rules and regulations; publication of harmful acts; disapproval of by-laws, etc

The Commission is authorized—

(2) to refuse to register any person—

(A) if the prior registration of such person has been suspended (and the period of such suspension shall not have expired) or has been revoked;

(B) if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, (i) because such applicant, or, if the applicant is a partnership, any general partner, or, if the applicant is a corporation, any officer or holder of more than 10 per centum of the stock, at any time engaged in any practice of the character prohibited by this chapter or was convicted of a felony in any State or Federal court, or was debarred by any agency of the United States from contracting with the United States, or the applicant willfully made any material false or misleading statement in his application or willfully omitted to state any material fact in connection with the application, or (ii) for other good cause shown; or

(C) in the case of an applicant for registration as futures commission merchant, if it is found after opportunity for hearing that the applicant has not established that he meets the minimum financial requirements under section 6f of this title: *Provided*, That pending final determination under clause (B) or (C), registration shall not be granted: *And provided further*, That the applicant may appeal from a refusal of registration under clause (B) or (C) in the manner provided in section 9 of this title; and

[7] 7 U. S. C. § 6n (6) The Commission is authorized, without hearing, to deny registration to any person as a commodity trading advisor or commodity pool operator if such person is subject to an outstanding order under this chapter denying to such person trading privileges on any contract market, or suspending or revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or suspending or expelling such person from membership on any contract market.

[8] Section 8a(2) of the Act may also in certain instances be violative of constitutional due process. Appendix A at 6 n. 6.

CFTC assertedly denied British American's registration and brings this preliminary injunction action pursuant to the third special situation, Section 8a(2)(B)(ii) of the Act:

> The [CFTC] is authorized . . . to refuse to register any person . . . if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made . . . (ii) for other good cause shown. *See* Appendix A at 6.

CFTC asserts that because it found "other good cause" and denied British American's registration, this court must grant a preliminary injunction denying British American the opportunity to do business pending the final determination of the administrative hearing on whether British American is fit to be registered as a "commodity trading advisor".

Such an automatic result is contrary to the equity discretion of this court and is too harsh a result for British American. At the hearing before this court CFTC offered no evidence to support its finding of "good cause shown" and no evidence as to why the public interest requires prohibiting British American from doing business pending the final determination of the administrative proceeding. CFTC did not allege nor offer any proof that British American defrauded or misled its customers or in any way conducted its business illegally or unethically.

The only indication in the record of CFTC's reasons for denying British American's registration are two outstanding consent decrees with the SEC against the principal owner of British American, John Forma.[9] No background leading up to the entering of these decrees nor any evidence of past illegal behavior of John Forma were offered. While the court expresses no opinion as to whether these consent decrees are grounds for a final determination of unfitness to be registered, these bare consent decrees, without any indication of unfair dealing by British American, do not constitute a "proper showing" for a preliminary injunction prior to the final determination of the administrative proceeding.

The CFTC cites a July 1975 release of "Standards of Denial of Registration" to support its position that an SEC consent decree is a criterion included in "for other good cause shown" under Section 8a(2)(B)(ii) of the Act. 40 Fed. Reg. 28125 (July 3, 1975). The release, however, only indicates that registration can be denied "for other good cause shown" *"after opportunity for hearing"* (emphasis added).[10] This failure to indicate that "good cause shown" is a ground for a pre-hearing denial of registration gave British American no notice that by their going into business and applying for registration as "commodity trading advisors" they could not take advantage of automatic registered status at least until an opportunity for a hearing. In an act that generally provides for automatic registration or at least requires a hearing prior to denial of registration, routine pre-hearing injunctions resulting from an expansive use of "other good cause shown" would undercut the intent of the Act.

The CFTC's position that this court must grant a preliminary injunction once CFTC has met its burden of showing British American is a "commodity trading advisor" ignores this court's discretion in

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[9] 1. Consent Judgment of Permanent Injunction in 70 Civ. 1743 (S. D. N. Y.) and consents of John Forma and John Forma Securities, Inc.

2. Consent Judgment of Permanent Injunction in 73 Civ 643 (S. D. N. Y.) and consents of John Forma and Forma Securities, Inc.

[10] CFTC "Standards for Denial of Registration", 40 Fed. Reg. 28125-26:

> . . . However, other provisions in section 8a(2) are not so specific, such as the authority *after opportunity for hearing* to deny registration for having engaged in a practice of the character prohibited by the Act. In addition, the Commission is authorized, *after opportunity for hearing,* to deny registration if "for other good cause shown", the applicant is unfit to engage in the business for which he has made application for registration. These criteria are not specific and need Commission interpretation. The Commission has interpreted "for other good cause shown" to include the following:
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> * * *
>
> (ii) At the time of the application is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction, or by agreement or settlement to which the Commission or the *Securities and Exchange Commission* is a party from acting as a commodity trading advisor.
>
> * * *
>
> This interpretation regarding "for other good cause shown" is not exclusive; i.e., there may be other instances for which the Commission, *after opportunity for hearing,* may determine to deny registration. (emphasis added)

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equity jurisdiction. *See Hecht Co. v. Bowles, supra* at 327-30; *SEC v. Management Dynamics, supra* at 807-09. A critical question in granting an injunction is whether "there is a reasonable likelihood that the wrong will be repeated." *SEC v. Manor Nursing Centers, Inc.*, 458 F. 2d 1082, 1100 (2d Cir. 1972); *see SEC v. Management Dynamics, supra* at 807. Here the mere continuation of business after the CFTC has found "good cause" to deny registration is not the necessary repetition of a wrong to grant an injunction. Rather, there must be some indication that a wrong connected with fraud or misconduct, herein related to the alleged activity that led up to the consent decree, is to be repeated. The CFTC introduced no evidence of any illegal behavior of John Forma either leading up to the consent decree or repeated with British American. Absent such repetition, a preliminary injunction cannot be granted under the facts of this case.

The court in its discretion in deciding upon the requested preliminary injunction must balance the public interest against the private interest of British American. On one side, "[i]n the formulation of its discretion [the court] recognize[s] that the public interest, when in conflict with private interests, is paramount." *SEC v. Culpepper*, 270 F. 2d 241, 250 (2d Cir. 1959); *see SEC v. Management Dynamics, supra* at 809 n. 5. However, "[t]he adverse effect of an injunction upon defendants is, of course, a factor to be considered." *SEC v. Broadwall Securities, Inc.*, 240 F. Supp. 962, 967 (S. D. N. Y. 1965); *see SEC v. Harwyn Industries Corp.*, 326 F. Supp. 943, 957 (S. D. N. Y. 1971); *CFTC v. J. S. Love & Assoc., supra* at 21,107.

In this case British American since October 1975 has built up a business with approximately one hundred employees, one million dollars in net worth,[11] and close to two thousand customers. Enjoining it from doing business until a final determination of the administrative proceeding now set for a hearing before the administrative law judge on November 15, 1976 would be too harsh a result.[12] If the administrative law judge decides after a full hearing on the merits that British American is fit to be registered, a prior preliminary injunction would in the short time prior to that final determination have irreparably injured British American's business, forcing their employees out of work. British American's customers would also be hurt. British American does not charge when a customer closes out its transaction. With British American out of business, its customers would have to pay another dealer to close out their options. If the administrative proceeding results in a final determination denying registration, the finding would put British American out of business. In the interim, British American, with no evidence that it is mistreating or misleading its customers or the general public does no apparent harm to the public interest by being allowed to do business. The purposes that would be served by issuance of a preliminary injunction are outweighed by the "harmful impact on the business reputation . . . and legitimate business activities" of British American. *SEC v. Harwyn Industries, supra* at 957; *see CFTC v. J. S. Love & Assoc., supra* at 21,107.

After consideration of the record, testimony at the hearing and other circumstances, the court concludes in the exercise of its discretion that a preliminary injunction against British American is unwarranted. As a result, the court grants defendant's request for a directed verdict. This decision is in no way an indication on the merits of the issues to be decided before the administrative law judge.

The foregoing constitutes the court's finding of fact and conclusions of law as required by Rule 52(a) Fed. R. Civ. P.

So Ordered.

## APPENDIX A

Plaintiff Commodity Futures Trading Commission ("CFTC") moves for a preliminary injunction to enjoin defendant British American Commodity Options Corp. ("British American") from making use of the mails or any means or instrumentality of interstate commerce in violation of Section 4m of the Commodity Exchange Act, as amended ("the Act"). 7 U. S. C. Section 6m.[1] The defendant cross-moves to dismiss the action pursuant to Rule 12(b) (1), (2) and (6), Federal Rules of Civil Procedure, for lack of jurisdiction and for the failure of the complaint to state a claim upon which relief can be granted.

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[11] Affidavit of John Forma in Opposition to Plaintiff's Request for a Preliminary Injunction, p. 2 (August 6, 1976).

[12] The CFTC waited until July 22, 1976 to bring its preliminary injunction action. If CFTC's allegations are correct, an action could have been commenced shortly after it learned that British American had started doing business unregistered in October 1975 and before British American had developed its sales force and its clientele to its present strength. CFTC even chose to wait an additional three months after April 16, 1976, the date it acted pursuant to Section 8a(2)(B) of the Act to deny British American's application, to bring this action.

This court has jurisdiction under Section 6c of the Act, 7 U. S. C. Section 13a-1,[2] where the defendant transacts business within this district or where alleged violations of the Act have occurred within this district. For the reasons stated herein, the court denies defendant's motions to dismiss and orders an evidentiary hearing to determine whether British American should be enjoined from doing business as a commodity trading advisor pending the conclusion of the administrative proceeding now ongoing.

Plaintiff CFTC is a duly constituted independent regulatory agency of the United States of America which, since April 21, 1975, has been charged with the responsibility for administering and enforcing the various provisions of the Act. 7 U. S. C. Section 1 *et seq.* Defendant British American, incorporated under the laws of the State of New York in October 1975, is engaged in the purchase and sale of London Commodity options, which are options to purchase certain commodity futures contracts.

This court heard oral argument on all of the motions in this case on September 24, 1976. Certain facts, necessary to the determination of the motions in this case, were stipulated to by the parties on the record or in their papers submitted to the court. These facts are set forth in chronological order. On or about March 3, 1976 the Division of Enforcement of the CFTC orally advised the defendant that it was the CFTC's position that defendant qualified as a "commodity trading advisor" under Section 2(a) of the Act, 7 U. S. C. Section 2,[3] and should register with the CFTC as required by Section 4m of the Act, *supra.* Thereafter, on March 17, 1976, British American, without conceding that the CFTC had jurisdiction over its activities, filed an application for registration on Form CFTC 5-R. The application was returned with a request for additional biographical data. The application was resubmitted on March 23, 1976. On April 16, 1976 the CFTC filed a "Complaint and Notice of Hearing pursuant to Section 4

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[1] 7 U. S. C. § 6m. Same; use of mails or other means or instrumentalities of interstate commerce

It shall be unlawful for any commodity trading advisor or commodity pool operator, unless registered under this chapter, to make use of the mails or any means or instrumentality of interstate commerce in connection with his business as such commodity trading advisor or commodity pool operator: *Provided*, That the provisions of this section shall not apply to any commodity trading advisor who, during the course of the preceding twelve months has not furnished commodity trading advice to more than fifteen persons and who does not hold himself out generally to the public as a commodity trading advisor.

[2] 7 U. S. C. § 13a-1. Action to enjoin or restrain violations; compliance; writs and orders; jurisdiction and venue; process

Whenever it shall appear to the Commission that any contract market or other person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of this chapter or any rule, regulation, or order thereunder, or is restraining trading in any commodity for future delivery, the Commission may bring an action in the proper district court of the United States or the proper United States court of any territory or other place subject to the jurisdiction of the United States, to enjoin such act or practice, or to enforce compliance with this chapter, or any rule, regulation or order thereunder, and said courts shall have jurisdiction to entertain such actions: *Provided*, That no restraining order or injunction for violation of the provisions of this chapter shall be issued ex parte by said court. Upon a proper showing, a permanent or temporary injunction or restraining order shall be granted without bond.

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Any action under this section may be brought in the district wherein the defendant is found or is an inhabitant or transacts business or in the district where the act or practice occurred, is occurring, or is about to occur, and process in such cases may be served in any district in which the defendant is an inhabitant or wherever the defendant may be found. . . .

[3] 7 U. S. C. § 2 • • • The term "commodity trading advisor" shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities; but does not include (i) any bank or trust company, (ii) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation including their employees, (v) any contract market, and (vi) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order:

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(n)7 and 8a(2) of the Commodity Exchange Act, as amended." 7 U. S. C. Sections 6 (n)7[4] and 12a(2).[5] The Complaint alleged that the defendant is unfit to be registered as a commodity trading advisor. The final determination of this question was referred to an administrative law judge and a prehearing conference is scheduled to take place before Administrative Law Judge Hunt on October 8, 1976. The CFTC in the Complaint stated that it deemed it appropriate not to grant registration to the defendant pending final determination of the administrative hearing. The instant claim was instituted here in this court by order to show cause on July 22, 1976.

At the outset, the defendant British American's motions to dismiss the CFTC's action must be denied in all respects. The doctrine of primary jurisdiction has no application to this motion for a preliminary injunction. The pendency of an administrative proceeding is irrelevant. CFTC specifically seeks to enjoin the defendant from doing business pending the final determination of the administrative proceeding. Section 6c of the Act, *supra*, allows the CFTC to bring such an action in federal court and the specific language of the Act, as described in detail below, allows the CFTC to act before the administrative proceeding is completed. See Section 8a(2)(B) and (C) of the Act, *supra*. As set forth below, until British American is registered it is prohibited by the Act from doing business as a commodity trading advisor. Because of the CFTC's action under Section 8a(2) of the Act, British American cannot be registered unless and until after a hearing its fitness to be registered is determined. This action only seeks to preliminarily enjoin the defendant until there is a final determination in that hearing. If it is in the public interest to stop British American from doing business, CFTC need not wait, while the unregistered defendant makes unauthorized transactions, until the administrative hearing is complete. As such, on the face of its complaint, the CFTC has stated a cause of action.

The Commodity Futures Trading Commission Act of 1974 authorizes the CFTC to seek injunctive relief in the appropriate United States District Court to enjoin violations of provisions of and rules promulgated under the Act and to enforce compliance wtih the Act. Section 6c of the Act, *supra*. This court, before it can grant the requested preliminary injunction, must first review the CFTC's actions to determine whether they comply with the requirements of the Act. If the court finds that the CFTC's actions are in compliance with the Act, it must then, in accordance with the standards established in this Circuit, set the matter down for an evidentiary hearing, as it is doing today, to independently judge the need for a preliminary injunction. And the appropriate citations are: *SEC v. Management Dynamics*, 515 F. 2d 801, pages 806 and 807; *SEC v. Frank*, 388 F. 2d 486, at pages 491-92; and *CFTC v. J. S. Love & Associates*, 76 Civ. 928, in the Southern District of New York, this year.

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[4] 7 U. S. C. § 6n (7) The Commission after hearing may by order deny registration, revoke or suspend the registration of any commodity trading advisor or commodity pool operator if the Commission finds that such denial, revocation, or suspension is in the public interest and that—

(A) the operations of such person disrupt or tend to disrupt orderly marketing conditions, or cause or tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities;

(B) such commodity trading advisor or commodity pool operator, or any partner, officer, director, person performing similar function or controlling person thereof—

(i) has within ten years of the issuance of such order been convicted of any felony or misdemeanor involving the purchase or sale of any commodity or security, or arising out of any conduct or practice of such commodity trading adivosr or commodity pool operator or affiliated person as a commodity trading advisor or commodity pool operator; or

(ii) at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from acting as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or as an affiliated person or employee of any of the foregoing, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of commodities or securities; or

[5] 7 U. S. C. § 12a. Registration of commission merchants and brokers; fees; rules and regulations; publication of harmful acts; disapproval of by-laws, etc.

The Commission is authorized—

* * *

(2) to refuse to register any person—

(A) if the prior registration of such person has been suspended (and the period of such suspension shall not have expired) or has been revoked;

(B) if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, (i) because such applicant, or, if the applicant is a partnership, any general partner, or, if the applicant is a corporation, any officer or holder of more than 10 per centum of the stock, at any time engaged in any practice of the character prohibited by this chapter or was convicted of a felony in any State or Federal court, or was debarred by any agency of the United States from contracting with the United States, or the applicant willfully made any material false or misleading statement in his application or willfully omitted to state any material fact in connection with the application, or (ii) for other good cause shown; or . . .

The court must first examine the statutory language and relevant legislative history and CFTC rules and regulations. Section 4n(2) of the Act, 7 U. S. C. Section 6n(2), is the starting point of an examination of CFTC's claim that British American is not registered. That section provides as follows:

> "Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission, or within such shorter period of time as the Commission may determine."

This automatic registration provision is not affected where the CFTC, in accordance with the "as hereinafter provided" language acts within thirty days. In this case a question has arisen as to whether the registration period began on March 17 or March 23, 1976, which is the date of the amended application. Even with the first date applicable, the CFTC's actions on April 16, 1976 are within the required thirty-day period. Under the CFTC Rules of Practice Chap. 1 Section 10.5, the date of filing is not included in the computation of time. 41 Federal Register 2512, filed on January 16, 1976.

Consequently, the CFTC actions within the thirty days to prevent the automatic registration under Section 4n(2) of the Act.

A careful examination of the statute shows that CFTC's actions on April 16, 1976 satisfy the "as hereinafter provided" exception to 4n(2). First, while the Act is unclear as to whether the "as hereinafter provided" language applies only to Section 4n or to the entire Act, the legislative history makes it clear that the language means "as provided elsewhere in the Act." Senate Report No. 93-1131, 93rd Cong. 2d Sess. Section by Section Analysis, Section 205 (1974).

The CFTC therefore properly alleges that it is acting pursuant to Section 8a(2) of the Act, *supra*. Specifically, under Section 8a(2)(B)(ii) of the Act, the CFTC is:

> [A]uthorized to refuse to register any person . . . if it is found after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, . . . (ii) for other good cause shown.

While this language appears to require a hearing prior to the denial of registration, Section 8a(2)(C) of the Act specifically states: "Provided, That pending final determination under clause (B) or (C), registration shall not be granted." The initial decision not to grant registration can be made by the CFTC prior to any hearing being required.[*] This clear meaning of the Act is reinforced in the legislative history, which states:

> In determining whether to register an applicant for a full period, the Commission may refuse to grant such registration for any of the reasons specified in Section 8a(2) of the Commodity Exchange Act, as amended, and the Commission may do so "pending final determination" as provided in that section. Senate Report No. 94-73, 94th Cong. 1st Sess. 5 (1975).

Once CFTC determined that British American is a "commodity trading advisor" and denied its application for registration for what it determined to be "good cause shown," CFTC could properly allege that British American's use of the mails or any means or instrumentality of interstate commerce in connection with its business as a commodity trading advisor was in violation of Section 4m of the Act, *supra*. The CFTC could properly bring an injunctive proceeding in this court to restrain such use of the mails or interstate commerce pending a final determination of the administrative

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[*] The statutory language covering the requirement and timing for a hearing under the Commodity Exchange Act, as amended, is very different from the more specific language in other regulatory acts. For example, Section 11 of the Securities Exchange Act, as amended, 15 U. S. C. § 78o (1975), specifically requires that a registration hearing for brokers and dealers be held and concluded within 120 days of the date of filing the application for registration (to be extended up to 90 additional days for good cause). 15 U. S. C. § 78o(b)(1)(B). While the CFTC's failure to hold a timely hearing is not a violation of the Commodities Exchange Act, it may in some instances be violative of constitutional due process. This court notes, however, that in this case to date there have been no unreasonable delays in the holding of the hearing and because British American has been allowed to trade while not registered, there could in any case be no prejudice due to postponements in the hearing.

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proceeding. Section 6c of the Act, 7 U.S.C. Section 13a-1. This court must determine if there are proper grounds for granting a preliminary injunction in this case and accordingly is prepared to proceed with the evidentiary hearing.

It is so ordered.

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### [¶ 20,225] Recommended Policies on the Cash Market Regulatory Authority and Cash Data Needs of the Commodity Futures Trading Commission, Report of the Advisory Committee on Definition and Regulation of Market Instruments.

Commodity Futures Trading Commission. October 18, 1976. Recommendations and Conclusion excerpted from report.

Cash Markets—Manipulation—Recommended Policy of Advisory Committee—Competition in Market Related to Manipulation.—Competition in cash markets has been interpreted by the CFTC Advisory Committee on Definition and Regulation of Market Instruments as an indication that the possibility of manipulation in that market is not an immediate concern. In recommending basically a "hands-off" policy for the Commission, the Advisory Committee examined various cash markets and determined that CFTC regulation was not clearly needed where there was active competitive trading. The tropical commodities, coffee, sugar and cocoa, were seen as adquately competitive in the world market. The highly competitive grain and livestock markets were also mentioned as areas where a positive program of cash market regulation was not indicated. The limited use of the copper and frozen concentrated orange juice futures markets was cited by the advisory report as an indication of areas where the CFTC should possibly investigate problems of competition in the cash markets and possible manipulation.

See ¶ 10,025 and 10,310, "Liabilities—Prohibitions" division.

Cash Markets—Manipulation—Action Recommended by Advisory Committee—Enforcement.—The Commodity Futures Trading Commission should confine its surveillance of cash markets to instituting enforcement actions against violations of the Commodity Exchange Act based on complaints received or from information received from outside sources. What constitutes "manipulation" has not been adequately defined in the CEA, according to the advisory committee, but the responsibilities of the CFTC do not expressly include the establishment of an affirmative regulatory program for cash markets. However, the CFTC is required to enforce the Act under Secs. 6(b), 6(c), and 9(b) against those who may manipulate the price of commodities in interstate commerce. It was recommended that the CFTC should undertake an affirmative surveillance effort only if there was a "clear and present danger" to the public, the areas of primary CFTC responsibility were affected, adequate CFTC resources existed, and any action taken would be for a minimal time period only. The advisory committee noted that most, if not all, manipulation situations involve violations of antitrust laws, and those federal and state agencies responsible for antitrust enforcement should be called in whenever possible. The implementation of any affirmative program by the CFTC was pictured as unworkable. The definition of "cash market" is too vague to draw appropriate parameters around the area of responsibility. The cost of an affirmative program would be prohibitive, even in a trouble-shooting approach, except in specific problem situations. Affirmative regulation would also mean, according to the report, the "politicizing of the Commission. Influences outside the market would control decisions made about some commodities, such as food. The committee recommended that the CFTC concentrate on monitoring the areas where the CFTC has primary responsibility, futures trading, options, and leverage transactions.

See ¶ 10,025 and 10,310, "Liabilities—Prohibitions" division.

Cash Markets—Cash Data Needs of the Commission—Recommended Policy of Advisory Committee—Increase in Cash Prices Information.—Citing a general lack of reliable cash price data, the CFTC was advised to order its priorities for data and then proceed through various recommended channels to obtain need cash market data. The needs of the Commission for spot market data were recounted as being for surveillance of the areas of primary responsibility, citing abnormalities of price which may affect

# AFFIDAVIT OF JAMES CARR

## AFFIDAVIT

I, James A. Carr, doing business as Lloyd, Carr Financial Company, 84 State Street, Boston, Suffolk County, Massachusetts, hereby make affidavit that:

1. Lloyd, Carr Financial Company is a commodity option dealer in the business of selling commodity options to its clients.

2. Lloyd, Carr is registered and has been approved as Commodity Trading Advisor by the Commodity Futures Trading Commission for such dealing in options.

3. To comply with new proposed regulations of the CFTC requiring registration as a Futures Commission Merchant in order to continue dealing in commodity options, and serving its clients needs, Lloyd, Carr completed it's Futures Commission Merchant application and submitted it, along with a check in the amount of $200 as required.

4. Some time later, the application now bearing the official receipt and time stamp of the CFTC was returned. No reason for the return was included, while the check was deposited and paid by Lloyd, Carr's bank of account.

5. Despite many phone calls to the CFTC, we were unable to extract from it the reason for the return, being told most of the time that the file could not be located but that someone would look for it and call us back.

6. Finally, approximately two weeks ago, we did receive a call and were told that certain additional information was required which information, they acknowledged, would take some time to gather.

7. The application has now been, or is at this moment being, delivered to the Commission.

8. Today, surprisingly, our counsel has advised us that the Commission has denied that we ever submitted an application. Accordingly we annex hereto copies both of the application bearing the official receipt stamp of the CFTC and the $200 check which it deposited. These exhibits refute at least these misrepresentations and distortions among the many which characterize the policies and actions of the CFTC in their headlong and extra-legal rush to restructure the commodity option industry and force the independents in it to suspend all operation.

Plaintiff respectfully suggests that a grave denial of the constitutional right of due process exists in this regulation as does a serious inconsistency with prior registration requirements in other categories.

For example, application for registration as a Commodity Trading Advisor automatically becomes effective within thirty (30) days of filing unless it is denied for good and stated statutory reasons. The rule concerning registration as a Futures Commission Merchant, however, does not require the CFTC to act within any given period of time.

Permitting a CFTC staff member thus to delay indefinitely action on an application does, when coupled with the subject requirement that all options dealers receive full approval by January 17, 1977, provide the CFTC with the ability effectively to eliminate due process and unilaterally, without reason and unconstitutionally suspend the business of any dealer merely by allowing the clock to tick.

It is again respectfully submitted that the CFTC would be denied such extra-legal power had the regulation indicated a mandatory date by which the application must be filed rather than one by which it must be approved.

We raised this point in District Court and feel that Court erred in not considering this issue.

Dated this Sixteenth day of January, 1977, at Boston, Massachusetts.

James A. Carr
JAMES CARR, d/b/a Lloyd, Carr Financial Co.

COMMONWEALTH OF MASSACHUSETTS

SUFFOLK, SS. January 16, 1977

The personally appeared the above-named James Carr d/b/a Lloyd, Carr Financial Company, and acknowledged that the statements set forth above in the foregoing affidavit are upon his own knowledge, information or belief and that those statements made upon information and belief he believes to be true, before me

William J. DiAngelis
Notary Public

My Commission Expires:
June 2, 1983

EXHIBIT TO AFFIDAVIT

A-704

EA-3196 [illegible]

| | | |
|---|---|---|
| U.S. DEPARTMENT OF AGRICULTURE<br>COMMODITY EXCHANGE AUTHORITY | APPLICATION FOR REGISTRATION<br>AS FUTURES COMMISSION MERCHANT | FORM APPROVED<br>OMB NO. 40-R0230 |

See instructions on page 1 reverse side

ENTER BELOW 1. NAME OF APPLICANT. 2. ADDRESS OF PRINCIPAL OFFICE. (Include number, street, city, state, and zip code.)

Lloyd Carr Financial Co.
84 State Street
Boston, MA 02109

AREA CODE AND TELEPHONE NO.:

617-723-3100

Applic[illegible]on is hereby made for registration as futures commission merchant for the calendar year ending December 31, 19 76, pursua[illegible] to requirements of the Commodity Exchange Act. Enclosed is remittance payable to the ~~Commodity Exchange Authority,~~ USDA, in the amount of $ 200.00----- to cover the prescribed fee. This consists of $200.00 for the principal office plus $6.00 each for __________ domestic branch offices and each correspondent and agent operating within the United States.

Commodity Futures Trading Commissio

3. Place where your general business records and those commodity records provided for by regulation under the Commodity Exchange Act will be kept.

| GENERAL BUSINESS RECORDS | COMMODITY RECORDS |
|---|---|
| 84 State Street #420<br>(No. Street and Room No.) | 84 State Street Boston, Mass.<br>(No. Street and Room No.) |
| Boston, MA 02109<br>(City, State and Zip Code) | Boston, MA 02109<br>(City, State and Zip Code) |

(a) Form of organization (Check one)

☒ PARTNERSHIP ☐ SOLE PROPRIETORSHIP ☐ CORPORATION

☐ OTHER (Specify)

(b) State in which incorporated, organized or established

. To be completed only if applicant or registrant is a PARTNERSHIP. List name of each partner. Denote special and limited partners by asterisk (*). Also list and denote by two asterisks (**) any other person possessing the power to direct or cause the direction of the management or policies of the applicant or registrant.

| NAME | ADDRESS (See Instruction C) | DATE AND PLACE OF BIRTH AND SOCIAL SECURITY NO. (See Instruction C) |
|---|---|---|
| Charles P. Lemieux, III | | |
| James A. Carr | | |

To be completed only if applicant or registrant is a CORPORATION OR OTHER FORM OF ORGANIZATION (other than a partnership or sole proprietorship). List name and title of each officer and director and each person owning or controlling more than 10% of the capital stock. Also list and denote by asterisk (*) any other person possessing the power to direct or cause the direction of the management or policies of the applicant or registrant.

| NAME AND TITLE | ADDRESS (See Instruction C) | DATE AND PLACE OF BIRTH AND SOCIAL SECURITY NO. (See Instruction C) |
|---|---|---|
| | | |

A-705

1 P1:07

7. To be completed only if applicant or registrant is a SOLE PROPRIETOR.

| NAME | ADDRESS (See Instruction C) | DATE AND PLACE OF BIRTH AND SOCIAL SECURITY NUMBER (See Instruction C) |
|---|---|---|
|  |  |  |

8. BRANCH OFFICES in the United States in which commodity futures orders are solicited or accepted in the name of the applicant. If NONE, check here [X]

| NAME OF BRANCH OFFICE MANAGER | COMPLETE ADDRESS OF BRANCH OFFICE | DATE AND PLACE OF BIRTH AND SOCIAL SECURITY NUMBER (See Instruction C) |
|---|---|---|
|  |  |  |

9. CORRESPONDENTS AND AGENTS *(excluding employees, salesmen, and registered representatives)* operating within the United States, authorized to solicit or accept commodity futures orders in the name of the applicant. If NONE, check here [X]

| NAME OF EACH CORRESPONDENT OR AGENT | PRINCIPAL ADDRESS OF OPERATION | DATE AND PLACE OF BIRTH AND SOCIAL SECURITY NUMBER (See Instruction C) |
|---|---|---|
|  |  |  |

Commodity exchanges under commodity exchange authority regulation in which you have membership, or enjoy membership privileges. If NONE, check here [X]

| REGULATED COMMODITY EXCHANGE (Designate by asterisk each exchange in which you are a clearing member) | PERSON WHOSE MEMBERSHIP IS REGISTERED FOR YOUR USE |
|---|---|
|  |  |

11. Have you or any general partner, officer, holder of more than ten percent of the capital stock, any person participating in managing your business or any of your offices, or any person authorized to solicit or accept commodity futures orders in your name been subject to or are any such persons currently involved in any of the following actions which you have not reported in writing to this agency, on a previous application or supplemental statement:

A-706

(a) Any action (including but not limited to refusal of membership, or suspension or expulsion therefrom) by a commodity or securities exchange or related clearing organization, or by a national securities association? . . . . . . . . . . Yes ☐ No ☒

(b) Any action by the United States Securities and Exchange Commission, the securities commission or equivalent authority of any State? . . . . . . . . . . Yes ☐ No ☒

(c) Any conviction of a felony? . . . . . . . . . . Yes ☐ No ☒

(d) Any conviction involving the handling of any commodity or securities account for any customer? . . . Yes ☐ No ☒

(e) Any debarment by an agency of the United States from contracting with the United States? . . . . . . . Yes ☐ No ☒

(f) Any action involving either voluntary or involuntary bankruptcy proceedings? . . . . . . . . . . Yes ☐ No ☒

If answer to any of the above is yes, furnish details below or on an attachment to this form.

2. Name and office address of partner, officer, or other individual to whom customer complaints are to be directed.

Charles P. Lemieux 84 State Street Boston, MA 02109

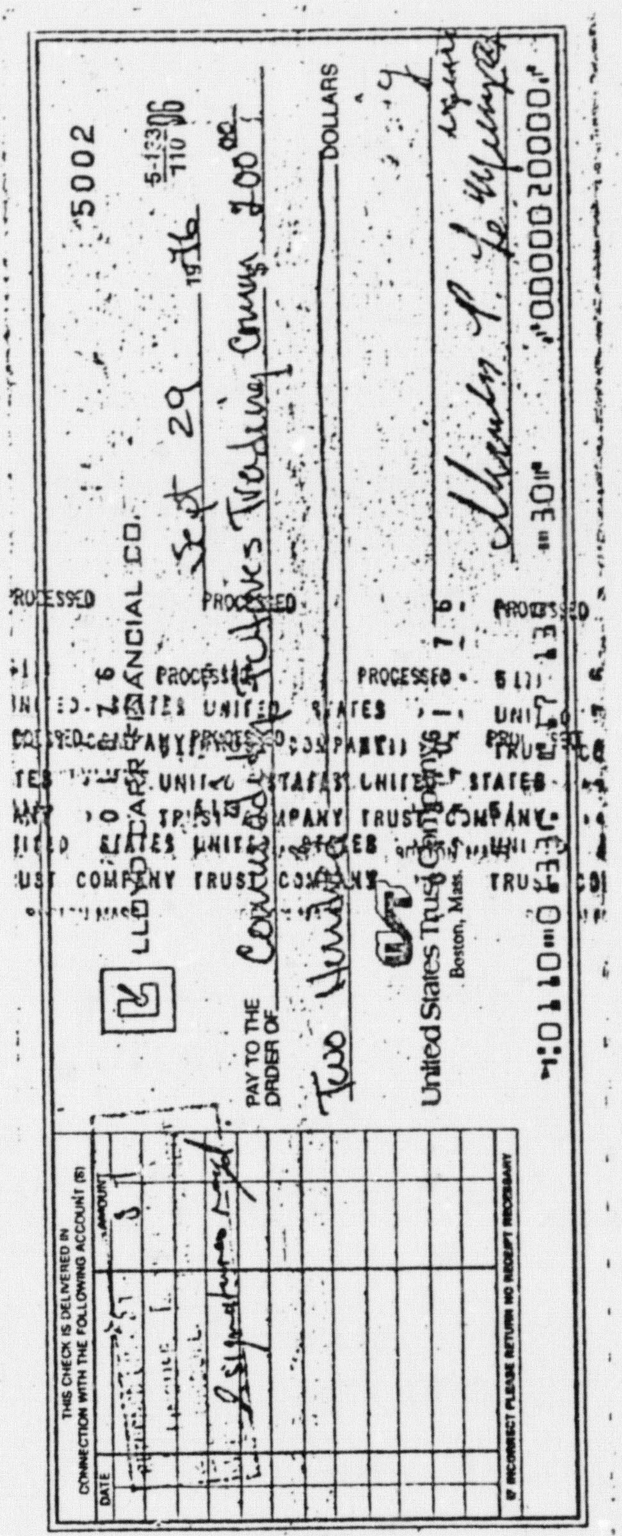
ful falsification or misrepresentation or willful omission of any material fact required to be stated in this application or state-
nt of financial condition or supporting schedules shall constitute cause for the suspension or revocation of registration and/or
secution under criminal statutes.

## CERTIFICATION

*(I) hereby represent that, to the best of our (my) knowledge and belief, all statements contained or incorporated in this appli-*
*on are true.*

Lloyd Carr Financial Co.
NAME OF APPLICANT

EXHIBIT TO AFFIDAVIT



THIS CHECK IS DELIVERED IN CONNECTION WITH THE FOLLOWING ACCOUNT (S)

| DATE | | AMOUNT |
|---|---|---|
| | | $ |
| | 2 signatures req'd | |

IF INCORRECT PLEASE RETURN NO RECEIPT NECESSARY

LLOYD CARR FINANCIAL CO.

5002

$\frac{5\text{-}133}{110}$ 96

Sept 29 1976

PAY TO THE ORDER OF Commodity Futures Trading Comm $ 200.00

Two Hundred DOLLARS

United States Trust Company
Boston, Mass.

⑆0110⑈0133 7 13 ⑈301⑈ ⑉0000020000⑉

PROCESSED

UNITED STATES TRUST COMPANY

EA-3196

1-120

Pay to the order of any
Federal Reserve Bank or
Branch or General Depos-
itory for credit to the
Treasurer of the United
States. (Depositor's
title-National Finance
Center SARU)
COMMODITY FUTURES
TRADING COMMISSION
61 Broadway
New York, N. Y. 10006

OCT 21 '75 35566
NEW YORK
1-120
507
A-120
NEW YORK

EXHIBIT B

X [illegible]

(g) *Separate extension of credit to married persons.* (1) A creditor may extend separate credit to each spouse if each applies for credit separately and voluntarily, any State law to the contrary notwithstanding.

(2) Where any state law is pre-empted by this section, each spouse is solely responsible for any such separate extension of credit. Where, in addition, the signatures of both spouses are necessary under the Act and paragraph (e) of this section in order to create a valid lien, pass clear title, waive inchoate rights to property or assign earnings, the creditor may require the signatures of both spouses without violating the Act or this Part.

(3) When each spouse separately and voluntarily applies for and obtains separate accounts with the same creditor, those accounts shall not be aggregated or otherwise combined for purposes of determining permissible finance charges or permissible loan ceilings under the laws of any State or of the United States. In any such case, however, the sum of the finance charges of the two separate accounts shall not exceed the finance charge which the creditor would have charged if the accounts had been combined, unless each spouse shall have separately and voluntarily requested a separate account in a separate, dated and signed personal statement which shall include a statement to the effect that the applicant knows that the separate account will require the applicant to pay a greater finance charge than if the accounts were combined. The use of printed or otherwise duplicated forms for such statements is prohibited unless the statement declares clearly and conspicuously and with greater prominence than any other portion of the statement, the fact that the applicant will pay a greater finance charge than if the accounts were combined.

(h) *Reevaluation of existing accounts.* A creditor may require that a new application be made in order to ascertain whether an applicant's financial circumstances have changed; and may terminate credit or change the conditions of credit where warranted by the creditor's standards of creditworthiness upon the occurrence of any of the following events only if the same policy is applied to both sexes on like occasions:

(1) A change in an applicant's marital status;

(2) Bankruptcy of an applicant's spouse;

(3) A denial of responsibility for an account by any party liable thereunder.

(i) A creditor shall apply ordinary standards of creditworthiness in determining whether:

(1) A particular applicant;

(2) The spouse of an applicant; or

(3) Both an applicant and his or her spouse together meet creditor's requirements for a particular requested extension of credit.

*Effective date:* The effective date of these Regulations shall be October 28,

*Notice and comments.* To aid in consideration of this proposal, a hearing will be held before available members of the Board on the terrace floor of its building on 20th and C Streets NW., Washington, D.C. on May 28 and 29, 1975, beginning at 10 a.m. The proceeding will consist of presentations of statements in oral or written form.

Any persons desiring to give testimony, present evidence, or otherwise participate in these proceedings should file with the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, on or before May 14, 1975, a written request containing a statement of the nature of the petitioner's interest in the proceedings, the extent of participation desired, a summary of the matters concerning which petitioner wishes to give testimony or submit evidence, and the names and identity of witnesses who propose to appear.

Interested persons need not participate in the proceedings through oral presentation in order to have their views considered.

Interested persons are invited to submit relevant data, views, and arguments concerning this proposal. Any such material should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received no later than June [illegible], 1975. Such material will be made available for public inspection and copying upon request, except as provided in § 261.6(a) of the Board's rules regarding availability of information. All views previously expressed in written comments on the pending proposal are under consideration by the Board and are available for inspection and copying in Room 1020 of the Board's building. Anyone wishing to submit written comments on the issues to be considered at the hearing may do so at any time before the close of business on May 14, 1975.

This notice is published pursuant to section 553(b) of Title 5 United States Code, and § 262.2(a) of the rules of procedure of the Board of Governors of the Federal Reserve System (12 C.F.R. 262.2(a)).

By order of the Board of Governors, April 22, 1975.

[SEAL] THEODORE E. ALLISON,
*Secretary of the Board.*

[FR Doc.75-10846 Filed 4-24-75;8:45 am]

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## COMMODITY FUTURES TRADING COMMISSION

[ 17 CFR Part 1 ]

## COMMODITIES OR COMMODITY FUTURES CONTRACTS; LEVERAGE CONTRACTS FOR GOLD AND SILVER; DOMESTIC SALES OF FOREIGN FUTURES CONTRACTS

### Antifraud Rules

The Commodity Futures Trading Commission ("Commission") is considering the [illegible] applicable to the following types of transactions:

(a) Transactions that involve any commodity and that are of the character of, or are commonly known to the trade as, an "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guaranty" or "decline guaranty";

(b) Transactions for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins that are executed pursuant to standardized contracts commonly known to the trade as margin accounts, margin contracts, leverage accounts or leverage contracts; and

(c) The solicitation or acceptance in the United States of orders for commodity futures contracts that are traded or executed upon boards of trade, exchanges or markets located outside the United States.

Under section 2(a)(1) of the Commodity Exchange Act ("Act"), 7 U.S.C. 2, as amended by section 101(b) of the Commodity Futures Trading Commission Act of 1974, Pub. L. 93-463, 88 Stat. 1395, the Commission has "exclusive jurisdiction" with respect to

> Accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 217 of the Commodity Futures Trading Commission Act of 1974 * * *.

As Congress recently recognized: "In transactions covered in sections 201 and 217 of the Act [the CFTCA], it is incumbent that the Commission act as speedily as possible to exercise its regulatory prerogatives in these areas to prevent the creation of any possible gaps in regulation."[1]

The Commission views these proposed rules as interim measures and may adopt additional regulations in the three above-described areas after further study. If adopted, the instant rules may be combined into a single rule.

1. *Commodity Options.* Under sections 4c(b) and 8a(5) of the Act, 7 U.S.C. 6c(b) and 12a(5), the Commission has regulatory authority over any transaction that involves a commodity and that is "of the character of, or is commonly known to the trade as, an 'option', 'privilege,' 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty.'" Congress conferred this authority upon the Commission because "trading in * * * options relating to commodities or commodity futures * * * is now poorly regulated, if it is

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[1] H. Rep. No. 94-122, 94th Cong., 1st Sess. 8 (1975).

regulated at all."[*] However, the Act's main antifraud provision, section 4b, may not apply to option transactions involving commodities or commodity futures contracts since those transactions are not made "on or subject to the rules of any contract market." Accordingly, unless and until the Commission adopts an antifraud rule applicable to these option transactions, the Commission may be unable to provide purchasers of these options with the degree of protection Congress clearly intended them to have.

Pursuant to the authority of sections 4c(b) and 8a(5) of the Act, the Commission proposes to adopt the following antifraud rule.

**§ 1.____ Commodity options.**

It shall be unlawful for any person, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce in, or in connection with, an order to make, or the making of, any transaction involving any commodity regulated under the Act but not specifically set forth in section 2(a)(1) of the Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty',

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

The proposed rule is intended to apply to sales in the United States of foreign as well as domestic options.

2. *Leverage Contracts.* Under section 217(a) of the CFTCA, 88 Stat. 1405, and section 8a(5) of the Act, the Commission has authority to adopt rules designed to prevent fraud in connection with transactions for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins that are executed pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract. However, as in the case of commodity options, the Act's main antifraud provision, section 4b, may not apply to such transactions because they are not made on or subject to the rules of any contract market. Since Congress clearly intended the Commission to regulate these transactions, the Commission considers it important that an antifraud rule applicable to such transactions become effective promptly. The text of the proposed rule is as follows:

**§ 1.____ Leverage contracts.**

It shall be unlawful for any person, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce in, or in connection with, an order to make, or the making of, any transaction for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account or leverage contract,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

3. *Domestic Sales of Foreign Futures Contracts.* While the Commission has a vital interest in the manner in which orders for commodity futures contracts are solicited or accepted in the United States, the Act's main antifraud provision may not apply if the futures contract in question is traded or executed upon a foreign market. As stated above, section 4b applies only to transactions made on or subject to the rules of a board of trade designated as a contract market, and the section of the Act that requires designation, section 4, 7 U.S.C. 6, [illegible] to boards of trade located in the United States. Thus, in order to [illegible] purchasers of foreign futures contracts from fraudulent schemes, the Commission is considering the adoption of an antifraud rule that would [illegible] follows:

**§ 1.____ Domestic sales of foreign futures contracts.**

It shall be unlawful for any person, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce in, or in connection with, any order to make, or the making of, any contract of sale of any commodity for future delivery that is traded or executed on any board of trade, exchange or market located outside the United States,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Interested persons may participate in this proposed rulemaking by submitting evidence in written form to the Commission at the following address: Commodity Futures Trading Commission, Room 149-W, Administration Building, U.S. Department of Agriculture, 14th St. and Independence Ave., S.W., Washington, D.C. 20250. All comments received on or before May 16, 1975 will be considered before final action is taken on the proposals. The Commission considers this to be an appropriate notice period because of the nature of the rules and the urgent need to declare the proposed rules effective as soon as possible.

Issued in Washington, D.C. on April [illegible], 1975.

By the Commission.

WILLIAM T. [illegible],
Chairman.

[FR Doc.75-11115 Filed 4-24-75;11:[illegible]]

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[*] Statement of Chairman Talmadge on consideration of the Conference Report on H.R. 13113, October 10, 1974, in *Senate Committee Print, The Commodity Futures Trading Commission Act of 1974*, 93d Cong., 2d Sess. 6 (1974). Cong. Rec., October 10, 1974, p. S18848.

(1)

**EXHIBIT "C" TO MEMORANDUM**

EXHIBIT C
A-711

| Disk pt. No. | Previous life limit (cycles) | Revised life limit (cycles) |
|---|---|---|
| 3 | 15,000 | 8,500 |
| 4 | 15,000 | 8,500 |
| 15 | 15,000 | 8,500 |
| 16 | 15,000 | 8,500 |

This amendment becomes effective July 3, 1975.

(Secs. 313(a), 601, 603, Federal Aviation Act of 1958 (49 U.S.C. 1354(a), 1421, 1423); sec. 6(c), Department of Transportation Act (49 U.S.C. 1655(c)).)

Issued in Burlington, Mass., on June 12, 1975.

William E. Crosby,
*Acting Director,*
*New England Region.*

[FR Doc.75-16263 Filed 6-23-75;8:45 am]

[Airspace Docket No. 75-NW-15]

## PART 71—DESIGNATION OF FEDERAL AIRWAYS, AREA LOW ROUTES, CONTROLLED AIRSPACE, AND REPORTING POINTS

### Alteration of Federal Airways

The purpose of this amendment to Part 71 of the Federal Aviation Regulations is to realign several airways via the relocated Moses Lake, Wash., VOR.

A revolving sprinkler irrigation system recently installed near the site of the Moses Lake VOR has rendered the VOR and associated airways unusable. Therefore, the Moses Lake VOR is being relocated approximately five miles to the [illegible]hwest at Latitude 47°12'23"N., [illegible]gitude 119°18'47"W., and action is taken herein to realign the associated airways via the relocated Moses Lake VOR. V-2 and J-34 will be realigned via the relocated Moses Lake VOR, but no change in their legal descriptions in necessary, since their alignments are via direct radials to adjacent VORs.

Since the expeditious realignment of the airway structure in the vicinity of Moses Lake is in the interest of safety, and since the distances the airways will be moved are not significant, notice and public procedure thereon is impracticable. However, as it is essential that the realignments appear on appropriate IFR charts, these amendments will become effective on the next date the charts will be published.

In consideration of the foregoing, Part 71 of the Federal Aviation Regulations is amended, effective 0901 G.m.t., August 14, 1975, as hereinafter set forth.

Section 71.123 (40 FR 307) is amended as follows:

1. V-357 is revised to read "From Baker, Oreg., via Walla Walla, Wash.; Moses Lake, Wash.; INT of Moses Lake 271° and Wenatchee, Wash., 182° radials; to Wenatchee; including a N alternate from Moses Lake via Ephrata, Wash., to Wenatchee.

2. In V-448, "Moses Lake 238° radials" is deleted, and "Moses Lake 231° radials" [illegible]stituted therefor.

(Sec. 307(a), Federal Aviation Act of 1958 (49 U.S.C. 1348(a)); sec. (c), Department of Transportation Act (49 U.S.C. 1655(c)))

Issued in Washington, D.C., on June 18, 1975.

B. Keith Potts,
*Acting Chief, Airspace and*
*Air Traffic Rules Division.*

[FR Doc.75-16264 Filed 6-23-75;8:45 am]

[Airspace Docket No. 75-NE-16]

## PART 71—DESIGNATION OF FEDERAL AIRWAYS, AREA LOW ROUTES, CONTROLLED AIRSPACE, AND REPORTING POINTS

### Alteration of Transition Area

On page 19484 of the Federal Register dated May 5, 1975 (40 FR 19484), the Federal Aviation Administration published a Notice of Proposed Rule Making which would alter the Auburn, Maine, 700-foot Transition Area.

Interested parties were given thirty (30) days after publication in which to submit written data or views. No objections to the proposed regulations have been received.

In view of the foregoing, the proposed regulations are hereby adopted effective 0901 G.m.t., October 9, 1975.

(Sec. 307(a), Federal Aviation Act of 1958 (72 Stat. 749; 49 U.S.C. 1348); sec. 6(c), Department of Transportation Act (49 U.S.C. 1655(c)))

Issued in Burlington, Mass., on June 4, 1975.

Quentin S. Taylor,
*Director,*
*New England Region.*

In § 71.181 of Part 71 of the Federal Aviation Regulations (40 FR 449) the description of the Auburn, Maine 700-foot transition area is amended to read as follows:

Auburn, Maine

That airspace extending upward from 700 feet above the surface within a 5-mile radius of the Center, 44°03'00" N, 70°17'00" W of Auburn-Lewiston Municipal Airport; within 3 miles each side of the 204° and 024° bearing from the Poland Springs, Maine NDB, 43°57'42" N, 70°20'14" W, extending from the 5-mile radius area to 9 miles southwest of the NDB; within 2 miles each side of the 018° bearing from the Poland Springs, Maine NDB extending from the NDB to 13 miles northeast of the NDB.

[FR Doc.75-16265 Filed 6-23-75;8:45 am]

[Airspace Docket No. 75-NW-04]

## PART 71—DESIGNATION OF FEDERAL AIRWAYS, AREA LOW ROUTES, CONTROLLED AIRSPACE, AND REPORTING POINTS

### Alteration of Transition Area

On May 1, 1975, a Notice of Proposed Rulemaking was published in the Federal Register (40 FR 19019) stating that the Federal Aviation Administration was considering an amendment to Part 71 of the Federal Aviation Regulations that would (1) [illegible] Portland, Oregon, T[illegible] (2) delete the description [illegible] Washington, Transition [illegible] of Portland, Oregon, [illegible] description a separate entry [illegible].

Interested persons were [illegible] in which to submit [illegible] or arguments. No objections [illegible] received.

In consideration of the [illegible] amendment is hereby [illegible] change.

*Effective Date.* This [illegible] be effective 0901 G.m.t., on August 14, 1975.

(Sec. 307(a), Federal Aviation Act of 1958, as amended, (49 U.S.C. 1348(a)); sec. [illegible] Department of Transportation Act (49 U.S.C. 1655(c)).)

Issued in Seattle, Wash., on June 16, 1655(c)))

C. B. Walk, Jr.,
*Director,*
*Northwest Region.*

In § 71.181 (40 FR 441) the description of the Kelso, Washington and the Portland, Oregon Transition Areas are amended to read as follows:

Kelso, Washington

That airspace extending upward from 700 feet above the surface within a 5-mile radius of Kelso-Longview Airport (Latitude 46°07'12" W; Longitude 122°[illegible]), within 9.5 miles west of and 4.5 miles east of the 012 degree bearing from the Kelso, Washington, NDB (Latitude 46°[illegible] N; Longitude 122°54'40" W) extending from the NDB to 18.5 miles north of the NDB; within 5 miles each side of the [illegible] degree bearing from the Kelso NDB extending from the NDB 22.8 miles northwest.

Portland, Oregon

That airspace extending upward from 700 feet above the surface bounded on the north by Latitude 46°00'00" N, on the east by Longitude 122°05'00" W, on the south by Latitude 45°10'00" N and on the west by Longitude 123°30'00" W; that airspace extending upward from 1200' above the surface bounded on the north by a line [illegible] a point 3 miles offshore [illegible] 30" N extending easterly via [illegible] 30" N to Longitude 121°[illegible] W, [illegible] easterly along the south [illegible] Latitude 46°00'10" N, [illegible] W, on the east by V-25, on the [illegible] to Corvallis, VOR thence via [illegible] 00'00" N to a point 3 miles [illegible] the west by a line 3 miles [illegible] point of beginning.

[FR Doc.75-16266 Filed 6-23-75;[illegible]]

## Title 17—Commodity and Securities Exchanges

## CHAPTER I—COMMODITY FUTURES TRADING COMMISSION

## PART 30—FRAUD IN CONNECTION WITH COMMODITY TRANSACTIONS

On April 25, 1975, the Commodity Futures Trading Commission [illegible] in the Federal Register, 40 [illegible], notice that it was con[illegible] tion of antifraud rules [illegible] following types of transactions:

(A) Transactions that involve any commodity and that are of the character of, or are commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty";

(B) Transactions for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins that are executed pursuant to standardized contracts commonly known to the trade as margin accounts, margin contracts, leverage accounts or leverage contracts; and

(C) The solicitation or acceptance in the United States of orders for commodity futures contracts that are traded, or executed upon boards of trade, exchanges or markets located outside the United States.

The Commission invited interested persons to participate in the rule-making process by providing written, submissions to the Commission. The Commission has considered all of the comments and suggestions received and has determined to adopt rules in the form set forth below in lieu of the form proposed.

The operative language of the proposed rules tracked the antifraud provisions of Securities and Exchange Commission Rule 10b-5 under the Securities Exchange Act, 17 CFR 240.10b-5. While the Commission believes that the interpretive approach taken by the courts with respect to Rule 10b-5 would generally be satisfactory if applied to prevent deceptive acts and practices in connection with transactions covered by the options and foreign market antifraud rules, the Commission is persuaded, on the basis of comments [illegible] received, that uniformity of rules in the commodity area is desirable. As a result, the Commission feels it would be inappropriate generally to apply the language of Rule 10b-5 to the commodity futures or other transactions regulated under the Commodity Exchange Act, as amended, since this might invite an uncritical application of security law principles and practices.[1]

The operative language of the antifraud provision contained in section 4b of the Commodity Exchange Act, as amended, 7 U.S.C. 6b, is no less broad than Rule 10b-5 with respect to misrepresentations and deceptive acts and practices. And, as a provision designed specially for commodities transactions, this language would not present a similar risk of inappropriate interpretation. Thus, by adopting rules patterned upon antifraud provisions that Congress has approved as part of the statutory scheme of the Commodity Exchange Act, the Commission can fairly expect that the courts will adopt a consistent and uniform approach to the prevention of fraudulent and deceptive acts and practices under the Commodity Exchange Act.[2]

Some of the comments received by the Commission contended that the Commission is required—not merely permitted—to utilize the antifraud standards set forth in section 4b of the Commodity Exchange Act, rather than a provision like Rule 10b-5. But the existence of other antifraud provisions in the Act, as amended, demonstrates the basic fallacy of that position.[3] More importantly, however, that argument ignores the broad rulemaking authority granted to the Commission under the recent statutory amendments.

For the foregoing reasons, the Commission has determined as an alternative to its proposals to adopt antifraud provisions relating to transactions in commodity options and relating to transactions in futures contracts other than on domestic designated contract markets which are based upon language contained in section 4b. They are set forth below as §§ 30.01 and 30.02.

Notwithstanding the Commission's approach to the foregoing matters, the Commission is satisfied that an antifraud approach based upon the language of Rule 10b-5 under the Securities Exchange Act is appropriate with respect to transactions for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins that are executed pursuant to standardized contracts commonly known to the trade as margin accounts, margin contracts, leverage accounts or leverage contracts. [illegible] not transactions of a type [illegible] entered in the markets for [illegible] futures or cash commodities. [illegible] they are transactions of a [illegible] to which the antifraud [illegible] federal securities laws were [illegible] applied by the Securities and Exchange Commission prior to the enactment of the Commodity Futures Trading Commission Act. The Commission [illegible] reason to disturb the [illegible] these antifraud criteria to these [illegible] transactions. Accordingly, the Commission has adopted Rule 17 CFR [illegible], relating to transactions for the delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins that are executed pursuant to standardized contracts commonly known to the trade as margin accounts, margin contracts, leverage accounts or leverage contracts.

The Commission has also determined that these rules should be contained in a separate part of the Commission's rules, which will concern fraud in connection with commodity transactions. Accordingly, the Commission is designating a new Part 30 to Title 17 of the Code of Federal Regulations.

In consideration of the foregoing, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations by adding a new Part 30, as follows:

Sec.
30.01 Fraud in connection with commodity options.
30.02 Fraud in connection with transactions in futures contracts other than on domestic contract markets.
30.03 Fraud in connection with [illegible] transactions in silver or gold bullion or bulk coins.

AUTHORITY: (7 U.S.C. 2, 6c, 12a), 42 Stat. 998, 49 Stat. 1494, 1500, as amended by 49 Stat. 1491, 52 Stat. 205, 54 Stat. 1059, 63 Stat. 913, 69 Stat. 375, 82 Stat. 26, 413 and by sections 103, 201(5), 402(c), Pub. L. 93-463, 88 Stat. 1392, 1395, 1412; (7 U.S.C. 13a, 88 Stat. 1405).

### § 30.01 Fraud in connection with commodity options.

It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly,

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

(c) To deceive or attempt to deceive any other person by any means whatsoever;

in or in connection with an offer to enter into, the entry into or the confirmation of the execution of, any transaction involving any commodity regulated under the Commodity Exchange Act, as amended, but not specifically set forth in section 2(a) of the Commodity Exchange Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is or is held out to be of the character of, or is commonly known to the trade as an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'put,' 'call,' 'advance guaranty,' or 'decline guaranty.'

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[1] The Commission is particularly concerned with the possibility that determinations reached on commodity cases might misapply non-disclosure-of-information standards taken from securities laws decisions, although it fully appreciates that a failure to disclose information may operate as a fraud or deceit with respect to commodity transactions in [illegible] circumstances.

[2] In the rules it has adopted, the Commission has not used the concept of willful behavior, which is reflected in the statutory language. The Commission notes that at least two courts may have taken a restrictive view of the purpose of section 4b because of the requirement of willfulness in the statute. See, *Economou v. U.S. Department of Agriculture*, 494 F. 2d 519 (2d Cir. 1974) (per curiam) and *McCurnin v. Kohlmeyer & Co.*, 347 F. Supp. 573, 575-576 (E.D. La. 1972), *affirmed*, 477 F. 2d 113 (5th Cir. 1973). The Commission does not believe these decisions should have continued vitality as applied to the Act as recently amended. It is appropriate—particularly in light of the Commodity Futures Trading Commission Act of 1974—that all provisions of the Commodity Exchange Act, as amended, be broadly construed to effectuate their remedial purposes. *J. Sutherland, Statutes and Statutory Construction*, section 3302 at 225 (3d ed., Horack rev., 1943). *See, e.g., Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The courts have frequently held in the context of remedial legislation that willfulness connotes no more than an awareness of an act or omission and not whether the act or omission is understood to be unlawful. *See, e.g., Goodman v. Benson*, 286 F. 2d 896, 900 (7th Cir. 1961); *Teger v. Securities and Exchange Commission*, 344 F. 2d 5, 8 (2nd Cir. 1965); *cf. Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 n 5 (1973).

[3] In section 4o of the Commodity Exchange Act, as amended, 7 U.S.C. 6o, Congress imposed upon commodity trading advisors and commodity pool operators antifraud standards applicable to their relationships with their clients and participants which uses language contained in Rule 10b-5 (1) and (3).

### § 30.02 Fraud in connection with transaction in futures contracts other than on domestic contract markets.

It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce, directly or indirectly, in or in connection with any account, agreement or transaction involving any contract of sale of a commodity for future delivery, traded or executed on any board of trade, exchange or market other than a contract market designated pursuant to section 5 of the Commodity Exchange Act, as amended:

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) To make or cause to be made to any other person any false report or statement thereof or to enter or cause to be entered for any person any false record thereof;

(c) To deceive or attempt to deceive any other person by any means whatsoever in regard to any such account, agreement or transaction or the disposition or execution of any such account, agreement or transaction or in regard to any act of agency performed with respect to such account, agreement or transaction; or

(d) To bucket any order, or to fill any order by offset against the order or orders of any other person or without the prior consent of any person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person."

### § 30.03 Fraud in connection with certain transactions in silver or gold bullion or bulk coins.

It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in, or in connection with (1) an offer to make, or the making of, any transaction for the purchase, sale or delivery of silver bullion, gold bullion, bulk silver coins or bulk gold coins pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account or leverage contract or (2) the maintenance or carrying of any such contract.

The foregoing rules shall be effective on June 24, 1975.

The Commission is satisfied that it would be contrary to the public interest to delay the effectiveness of these rules for the thirty days normally required under the Administrative Procedure Act, as codified, 5 U.S.C. 553(d). The Commission has exclusive jurisdiction with respect to transactions that are the subject of these rules. Accordingly, until they become effective there will exist a regulatory gap that must be closed as quickly as possible. Moreover, since the rules adopted do no more than forbid fraudulent activities and impose no duty of affirmative action upon anyone, their immediate adoption will impose no hardships.

Issued: June 20, 1975:

By the Commission.

WILLIAM T. BAGLEY,
*Chariman, Commodity Futures Trading Commission.*

[FR Doc.75-16557 Filed 6-23-75;8:45 am]

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## CHAPTER II—SECURITIES AND EXCHANGE COMMISSION

[Rel. No. 34-11474]

## PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

### Monitoring of Competitive Commissions

The Commission today announced the amendment of Article 30-3 (17 CFR 200.30-3) of the Commission's Statement of Organization; Conduct and Ethics; and Information and Requests (17 CFR 200). Article 30-3 delegates, pursuant to Pub. L. 87-592, 76 Stat. 394 (15 U.S.C. 78d-1, 78d-2), certain authority to the Director of the Division of Market Regulation.

Rule 17a-20 (17 CFR 240.17a-20) and related Form X-17A-20 (17 CFR 249.636) were adopted as part of the Commission's monitoring of competitive commission rates. Among other things, Rule 17a-20 requires notification of an intention to resign a membership interest in a national securities exchange and periodic reporting to the Commission of revenues and expenses and related financial and other information by brokers and dealers whose revenues exceed certain amounts. Section (c) of the rule provides that the Commission, on written request of a national securities exchange, registered national securities association, broker or dealer, or on its own motion, may grant an extension of time or an exemption, either unconditionally or on specified terms or conditions, from any of the requirements of Rule 17a-20 or Form X-17A-20.

Pursuant to Pub. L. 87-592, 76 Stat. 394 (15 U.S.C. 78d-1, 78d-2), 17 CFR 200.30-3 (a)(12) is hereby added to read as follows:

### § 200.30-3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(12) Pursuant to Rule 17a-20(c) (§ 240.17a-20(c) of this chapter), to grant extensions of time and exemptions from any of the [illegible] 17a-20, (§ 240.17a [illegible] Form X-17A-20, (§ [illegible] ter), either [illegible] fied terms and conditions.

* * * * *

The Commission finds that [illegible] going amendment [illegible] agency organization, [illegible] tice and that notice of [illegible] the Administrative Procedure Act [illegible] U.S.C. 553) are not [illegible] 5 U.S.C. 553(b)(3)(A). [illegible] also finds that the amendment is not [illegible] substantive rule within the meaning [illegible] U.S.C. 553(d) and is therefore, effective June 16, 1975.

By the Commission.

GEORGE A. FITZSIMMONS,
*Secretary.*

JUNE 16, 1975.

[FR Doc.75-16291 Filed 6-23-75;8:45 am]

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## Title 18—Conservation of Power and Water Resources

## CHAPTER I—FEDERAL POWER COMMISSION

### SUBCHAPTER F—ACCOUNTS, NATURAL GAS ACT

[Docket No. RM75-6; Order 529]

## PART 201—UNIFORM SYSTEM OF ACCOUNTS FOR NATURAL GAS COMPANIES (CLASS A AND CLASS B)

### Order Amending the Uniform System of Accounts for Class A and Class B Natural Gas Companies

JUNE 17, 1975

On August 29, 1974, the Commission issued a notice of proposed rulemaking [illegible] Docket No. RM75-6 (39 FR 32156, September 5, 1974), proposing to amend Account 166, Advances for Gas Exploration, Development and Production, to provide further assurances that gas [illegible] from reserves developed or [illegible] a result of advance payments will [illegible] the advancing pipeline [illegible] and reasonable rate by [illegible] element of determining rate treatment that all advance payment agreements contain certain provisions for assurance.

Views and comments were invited [illegible] interested parties to be submitted [illegible] before October 15, 1974. [illegible] invitation, the Commission [illegible] ments from nineteen [illegible] respondent requested a conference because of the comp[illegible] of [illegible] sponses, no conference was held.

Basically, the proposed amendments to Account 166, Advances for Gas Exploration, Development and Production were as follows:

(1) Paragraph A of the account [illegible] be amended to require, as an element determining rate treatment[1]:

(A) the pipeline shall have first call [illegible] produced under [illegible] that (B) "the selling [illegible] gas shall be governed [illegible]

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[1] List filed as part of the original document.

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## EXHIBIT "D" TO MEMORANDUM

EXHIBIT

A-714

~~§ 50-[illegible]0.55 Effective date.~~

~~Signed at Washington, D.C. this 16th day of October, 1975.~~

~~J[illegible] Dunlop,~~
~~*Secretary of Labor.*~~

~~[FR Doc.75-28242 Filed 10-22-75;8:45 am]~~

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## COMMODITY FUTURES TRADING COMMISSION

### [17 CFR Chapter I]

### COMMODITY OPTIONS

### Temporary Regulations

The Commodity Futures Trading Commission is considering the adoption of rules to regulate—or perhaps forbid—transactions in commodity options, and has assigned to its Advisory Committee on Definition and Regulation of Market Instruments the responsibility of making an appropriate recommendations to the Commission on this matter. The Commission is soliciting the views of knowledgeable persons concerning whether one or another of several possible approaches presently being considered—or some other approach—should be adopted. The Commission is also considering what, if any, temporary rule might be promulgated, pending the adoption of more definite rules after receipt by the Commission of the Advisory Committee recommendations.

Section 4c(a)(B) of the Commodity Exchange Act, as amended, 7 U.S.C. 6c(a)(B), expressly forbids option transactions[1] relating to those commodities which were regulated under that Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974.[2] The 1974 Act expanded the definition of commodity to include "all other goods and services, rights and interests in which contracts for future delivery are presently or in the future dealt in . . . ." With respect to commodities that are newly within this expanded definition, Section 4c(b) of the Commodity Exchange Act, as amended, 7 U.S.C. 6c(b), now provides:

> No person shall offer to enter into, enter into, or confirm the execution of, any [commodity option] transaction . . . contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . . .[3]

Consequently, state-law provisions regulating the offer and sale of commodity options—at least those that involve commodity futures—have been preempted by the federal statute. *See, e.g.*, Conference Committee Report, S. Rep. No. 93-1194, 93d Cong., 2d Sess. at 35-36 (Sept. 30, 1974):

> "Under the exclusive grant of jurisdiction to the Commission, the authority of the Commodity Exchange Act (and the regulations issued by the Commission) would preempt the field insofar as futures regulation is concerned. Therefore, if any substantive State law regulating futures trading was contrary to or inconsistent with Federal law, the Federal law would govern. In view of the broad grant of authority to the Commission to regulate the futures trading industry, the Conferees do not contemplate that there will be a need for any supplementary regulation by the States."

Pursuant to this authority, the Commission has promulgated a rule broadly prohibiting deceptive acts or practices in connection with commodity option transactions.[4] Nevertheless, commodity-option offerings appear to have proliferated, and many of these offerings appear questionable since in most cases investors are not given adequate assurance that the issuers of the options will be able to perform their obligation under the option contracts when and if required to do so.

Thus, it is clear that the Commission must act further for the protection of investors. On the other hand, it would be inappropriate for the Commission to make any kind of definitive judgment concerning commodity options without [illegible] Commission's Ad[illegible] Definition and Regu[illegible] struments has been [illegible] ity to carefully consider and [illegible] the Commission its recommendations [illegible] appropriate regulation of [illegible] options.

Pending receipt of [illegible] mittee's recommendations, [illegible] Commission has been [illegible] sibility of adopting some form [illegible] measure. Accordingly, the [illegible] holding a hearing on [illegible] pursuant to which all [illegible] bers of the public may [illegible] views, in written form, con[illegible] relative merits of the following [illegible] alternatives or may suggest [illegible] alternatives that the Advisory Com[illegible] tee and the Commission might [illegible] consider. It is important that all [illegible] transmit their views to the C[illegible] as promptly as possible, since the C[illegible] mission may find that interim [illegible] an urgent matter and that it is [illegible] sary to implement a temporary rule [illegible] out further public notice.[5] If the C[illegible] mission should adopt a [illegible] all comments that the Commission [illegible] ceives after its adoption will be [illegible] ered with a view to possible [illegible] of the temporary rule. Of course, [illegible] ments will be made available to [illegible] utilized by the Advisory Committee [illegible] Definition and Regulation of [illegible] struments in formulating its [illegible] dations to the Commission, [illegible] considered by the Commission [illegible] promulgates a definitive rule.

1. *Prohibition of all Commodity [illegible] tions Transactions.* One [illegible] would be to prohibit all commodity [illegible] tions transactions. Of course, in [illegible] ering whether to prohibit [illegible] option transactions altogether, [illegible] an interim or permanent measure, [illegible] Commission must weigh the [illegible] while illegitimate operations would [illegible] outlawed, transactions that may be [illegible] tirely legitimate and which [illegible] serve desirable economic [illegible] also be barred. A [illegible] considered desirable if [illegible] tions are shown to have little [illegible] nomic utility, especially if [illegible] sion continues to [illegible] number of those who offer [illegible] options to the public [illegible] lent practices. The [illegible] appreciate public co[illegible] of a temporary or [illegible] tion, particularly [illegible] legitimate enterprises [illegible] ity options which [illegible] tial adverse effects from [illegible] whether they could, without [illegible]

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[1] The statute refers to any "transaction [which] is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guarantee', or 'decline guarantee'. . . ." Section 4(c)(a)(B), 7 U.S.C. 6c(a)(B). For convenience in this release, the Commission is utilizing the term "option" to include all transactions described by this provision.

[2] Prior to the effective date of the Commodity Futures Trading Commission Act of 1974, the Commodity Exchange Act provided for the regulation of

"... wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain, sorghums, millfeeds, butter, eggs, onions, solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice."

[3] Section 2(a)(1), 7 U.S.C. 2, of the Commodity Exchange Act provides (emphasis added):

"That the Commission shall have *exclusive jurisdiction* with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an option . . .), and transactions involving contracts of sale of a commodity for future delivery . . . ."

[4] 17 C.F.R. 30.01, 40 Fed. Reg. 26504, 26505 (June 24, 1975), reads as follows:

"30.01 *Fraud in connection with commodity options.* It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly,

"A. to cheat or defraud or attempt to cheat or defraud any other person;

"B. to make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof;

"C. to deceive or attempt to deceive any other person by any means whatsoever;

"in or in connection with an offer to enter into, the entry into or the confirmation of the execution of, any transaction involving any commodity regulated under the Commodity Exchange Act, as amended, but not specifically set forth in Section 2(a) of the Commodity Exchange Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is or is held out to be of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty.'"

[5] If the Commission should [illegible] a temporary rule, it [illegible] it should first hold a [illegible] presentations may be [illegible] tator should request [illegible] presentation. In any [illegible] plated that hearings, [illegible] oral testimony will [illegible] Committee at which [illegible] on the advisability of [illegible] be received.

detriment, easily divert resources presently devoted to option transactions to other profitable opportunities.

2. *Restricting Commodity Options Transactions to Contract Markets.* A second alternative would be to permit commodity options transactions only through the facilities of a board of trade that has been designated as a contract market pursuant to Section 5 of the Commodity Exchange Act, 7 U.S.C. 7. Since the Commission has broad regulatory authority over contract markets, it could assure adequate regulation of commodity options by use of the self-regulatory framework of the contract markets. Moreover, since options and futures trading have similarities, it would be consistent with the statutory scheme of the Act, which effectively limits commodity futures transactions to contract markets, to treat option transactions in the same way. If transactions in options were limited to contract markets, the Commission would be able to review and approve the forms of option contracts as it does with futures contracts, and the Commission could impose necessary or appropriate safeguards.[6] However, this form of regulation would have the effect of prohibiting persons who have established presumably legitimate option trading enterprises from continuing their activities unless, without serious detriment, their method of operation can be converted to effect transactions through the facilities of a contract market.

3. *Business Plans.* A third alternative would be the adoption of a rule that would forbid option transactions except in accordance with a business plan that has been approved by the Commission. Thus, persons offering or selling commodity options might be requested to file a business plan with the Commission setting forth the nature of the issuer's business and material information which would be disclosed to investors. Option transactions would not be permitted unless the Commission had approved the business plan of the person offering or selling the option. The Commission would retain authority under such a rule to permit or to require changes in any plan.[7]

The "business plans" approach would provide the Commission with the most direct and responsive regulatory measure; however, it would be the most costly for the Commission to implement because the Commission would have to commit substantial time, personnel and resources to the administration of these plans. In addition, any person submitting a business plan would incur great expense which, of course, would ultimately be borne by the customers.

4. *Prohibition against "Naked" Options.* In considering enactment of the Commodity Futures Trading Commission Act of 1974, one congressional committee stated that the Commission's authority to regulate or "ban" options on commodities futures should not be exercised to approve any commodity option transaction:

> . . . if the option or transaction . . . does not guarantee the purchase of the futures contract in fulfillment of the option, should the purchaser seek to exercise the option. The Committee intends the Commission to act as expeditiously as possible to prohibit such transactions.[8]

The unsecured transactions referred to by the committee are the so-called "naked" commodity options.[9]

The Commission might conclude that prohibition or restriction of "naked" options is appropriate regardless of its treatment of other option transactions. It appears clear that the offer of "naked" options has involved serious abuses. Further, concern has been expressed that trading in naked options serves "virtually no economically useful purpose."[10] If this approach should be taken, however, it would be necessary to define "naked options" and propose effective prohibitions or restrictions for such transactions.

Of course, this approach would not prevent all abuses related to option transactions, and some form of [illegible] or registration requirement as well as investigative activity might be [illegible] assure compliance.

5. *Registration with the Commission.* Another alternative [illegible] of commodity options would [illegible] commodity option transactions by [illegible] person not registered as a futures commission merchant. This approach [illegible] prevent option trading by [illegible] fail to meet the basic [illegible] standards that the Commodity [illegible] Act imposes, and would [illegible] Commission to determine the identity of persons who are offering options to the public. On the other hand, commodity option enterprises present somewhat different regulatory considerations than the normal business of futures commission merchants. Accordingly, somewhat different regulatory standards should presumably apply. Thus, even if registration as a futures commission merchant were adopted as an interim requirement, extensive study would be required to determine whether to adopt [illegible] amend Commission rules [illegible] segregation of customer funds, [illegible] of options and other customer protection standards.[11]

The Commission would appreciate comments concerning the issues raised [illegible] the foregoing discussion and, in addition, requests comments on the following specific matters.[12]

1. What useful economic functions are performed by commodity option trading? In what ways do existing offerings of commodity options perform these economic functions?

2. Could option trading have an adverse economic effect upon futures trading in terms of liquidity or otherwise? [illegible] so, do those economic effects differ [illegible] respect to agricultural as contrasted [illegible] non-agricultural commodities?

3. If option trading should be permitted, what form of regulation would [illegible] most appropriate and what [illegible] should be adopted further to [illegible] against fraudulent acts and practices [illegible]

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[6] If this alternative were selected, the Commission might, for example, adopt an interim regulatory rule patterned after Rule 17 C.F.R. 240.9b-1, adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, for securities options transactions effected through the facilities of a national securities exchange. That rule provides in part (emphasis supplied) that:

"It shall be unlawful for a national securities exchange, or for any member thereof, to effect any transaction in an option, or to permit any transaction in an option to be effected, by the use of the facilities of the exchange, *except in accordance with a plan regulating transactions in options on the exchange that is declared effective by the Commission pursuant to this rule.*"

[7] If adopted, this approach would be implemented through a rule similar to that proposed by the Commission for leverage contracts that are subject to Section 217 of the Commodity Futures Trading Commission Act. *See* 40 Fed. Reg. 35382 (August 20, 1975).

[8] H.R. Rep. No. 93-975, 93d Cong., 2d Sess. at 21 (1974).

[9] *See* Note, 73 Mich. L. Rev. 710, 720-721 (1975):

"Naked options are based on changes in futures prices but are not backed either by futures contracts or by actual ownership of the commodities involved. Limited capital requirements and lack of regulation make entering into naked options trading easy; the potential for abuse is correspondingly high. Moreover, naive investors are attracted to this area by its 'get-rich-quick' potential."

It was noted in the Senate hearings on the legislation that became the Commodity Futures Trading Commission Act of 1974 that ". . . naked options, as the name implies, are not covered by inventories of physical commodities or futures contracts for such commodities. Indeed, dealers admit that to cover their outstanding option contracts would tie up an enormous amount of their capital and make it unprofitable to operate. Rather, naked options 'represent nothing more than the seller's unsupported promise to perform.'"

*Hearings Before the Senate Committee on Agriculture and Forestry on S. 2485, S. 2578, S. 2837 and H.R. 13113,* 93d Cong., 2d Sess., pt. 3 at 828 (1974).

[10] *Hearings Before the Senate Committee on Agriculture & Forestry, supra* n. 9 at p. 828.

[11] Generally, persons who are [illegible] modity options to the public [illegible] to register with the Commission [illegible] modity trading advisors. Section 2 [illegible] vides that a commodity trading [illegible] one who, for compensation or [illegible] others as to the value of [illegible] advisability of trading in any [illegible] future delivery subject to the [illegible] contract market. A person who [illegible] such commodity options [illegible] some advice as to the "value of" the [illegible] modity underlying the option. One who [illegible] ports to offer and sell options on [illegible] futures contracts will advise [illegible] visability of trading" in futures [illegible] whether his advice is to purchase [illegible] contract or instead to purchase an option.

However, because [illegible] visors are not required to comply [illegible] minimum financial requirements [illegible] mission would be [illegible] whether the trading [illegible] otherwise [illegible] and [illegible] the terms of the option [illegible]

[12] In giving comments it would [illegible] if persons giving comments would [illegible] supporting factual data to the [illegible]

to provide financial safeguards to the customers of persons who are offering and selling options?

4. Should option trading in commodity futures contracts as well as in cash commodities be permitted? If so, what differences in regulation, if any, would be appropriate?

5. Should trading in "naked options" be banned or, if permitted, what, if any, particularized regulation should be imposed? For this purpose, how should "naked options" be defined?

6. What considerations should be weighed in determining whether option trading should be restricted to contract markets? If it is believed that option trading should be permitted otherwise than through the facilities of contract markets, what form of regulation would be appropriate?

7. What additional considerations, if any, would be relevant to whether or in what manner trading should be permitted in foreign commodity options, including the so-called "London" option?

The foregoing questions are not intended in any way to restrict or limit comment on the issues presented and constitute only a preliminary and very general survey by the Commission. The Commission seeks comment in any area that interested persons believe would be appropriate in as much detail as the commentator is willing to provide.

The Commission's consideration of interim as well as more permanent regulatory measures does not relieve any person of any requirement or obligation imposed by any provision of the Act or the rules, regulations and orders thereunder. Particular attention is directed to the antifraud regulations applicable to commodity options transactions. (17 C.F.R. 30.01.)

As noted above, the Commission is holding a hearing through written submissions on what permanent or interim proposal should be adopted by the Commission for the regulation of commodity options and interested persons are invited to express their views and comments concerning these proposals and the questions raised herein. To be considered, written statements of views and comments should be submitted to Commodity Futures Trading Commission, 1120 Connecticut Avenue, N.W., Washington, D.C. 20036, Attention: CCU, on or before November 11, 1975. In addition, any person may request the opportunity to express their views at an oral hearing. If the Commission should conclude that an oral presentation will be of value, it will, by subsequent notice, set the time and place of that oral hearing. All comments received will be available for public inspection.

Issued in Washington, D.C. on this 16th day of October 1975.

William T. Bagley,
*Chairman, Commodity Futures Trading Commission.*

[FR Doc.75-28432 Filed 10-21-75;8:45 am]

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## ENVIRONMENTAL PROTECTION AGENCY

[FRL 446-4]

[40 CFR Part 52]

## APPROVAL AND PROMULGATION OF STATE IMPLEMENTATION PLANS; ARIZONA

### Proposed Sulfur Oxide Control Strategy and Regulations for Existing Non-Ferrous Smelters

The purpose of this notice is to propose substitute regulations for control of sulfur oxide emissions at existing copper smelters in the Phoenix-Tucson Intrastate Region and the Arizona portion of the Arizona-New Mexico Southern Border Interstate Region. The preamble which follows contains the background for this action, a discussion of the air quality in the Regions, a description of the proposed regulations, announcement of public hearings and a request for written comments. The Administrator encourages public comment at the public hearings or in writing. The findings from all information available to the Administrator will form the basis of the final promulgation of Arizona sulfur oxide control strategy regulations for copper smelters.

### BACKGROUND

On May 31, 1972 (37 FR 10849) pursuant to section 110 of the Clean Air Act and 40 CFR Part 51, the Administrator disapproved the State of Arizona implementation plan for attainment and maintenance of the National Ambient Air Quality Standards for sulfur oxides in the Phoenix-Tucson Intrastate Region and the Arizona portion of the Arizona-New Mexico Southern Border Region. The Administrator's disapproval was based on the fact that the plan did not contain a control strategy nor regulations for sulfur oxides in these Regions. One day before, on May 30, the Governor of Arizona submitted a revision to the state plan. This revision was too late to be considered in the May 31 decision. However, on July 27, 1972 (37 FR 15081) the Administrator published in the FEDERAL REGISTER his decision on the May 30 revision to the Arizona plan. Specifically with respect to sulfur oxide emissions in the Phoenix-Tucson and Arizona-New Mexico Southern Borders Regions, the Administrator disapproved Regulation 7-1-4.1 of the Arizona Rules and Regulations, and emission limitation for existing copper smelters.

The Administrator's decision to disapprove Regulation 7-1-4.1 was based on several factors. First, the regulation did not define specific emission limitations for copper smelters. Using the proportional model equation, a mathematical technique for determining the amount of emission reduction needed to meet air quality standards, the regulation defined the degree of control needed to meet the primary annual standard for sulfur oxides in the vicinity of each smelter. However, the regulation [illegible] specify the air quality values [illegible] in the equation. In addition, [illegible] lation provided for adjusti[illegible] of control indicated by the [illegible] model based on diffusion model[illegible] The regulation also failed to [illegible] magnitude of this adjustment [illegible] plied to each [illegible] regulation was not [illegible] possible to evaluate and [illegible] or not it would have [illegible] tained the national [illegible] this regulation did not [illegible] nent control of emissions for smelters to achieve [illegible] ards for sulfur oxides including [illegible] hour standard. Instead of [illegible] control of emissions, the Arizona [illegible] lations require the use of "in[illegible] production curtailment such as [illegible] loop operational control" (defined [illegible] Arizona regulations as "the [illegible] tailment or cessation of smelter [illegible] sions in order to prevent the [illegible] of ambient air concentrations in [illegible] of the standards . . .") to achieve [illegible] difference between positive [illegible] meet the annual primary standard [illegible] that necessary to meet all other [illegible] oxide standards.

On July 27, 1972 (37 FR 150[illegible]) [illegible] ministrator proposed replacement [illegible] lations for control of sulfur oxides [illegible] ed by all existing smelters in [illegible] These regulations contained [illegible] emission limits for each Arizona [illegible] In these regulations, the amount of [illegible] trol required for attainment and [illegible] tenance of all national standards [illegible] based on available air quality [illegible] diffusion model estimates where [illegible] quality data was not available. The [illegible] quality data was in the form of [illegible] marized data submitted to EPA [illegible] then Arizona Division of Air [illegible] Control. Public hearings on the [illegible] replacement regulations were [illegible] Phoenix and Tucson on September [illegible] 3, 1972 respectively. In these [illegible] the air quality data was [illegible] by the smelting industry as [illegible] curate. EPA subsequently obtained [illegible] examined the raw data and [illegible] to the summarized data [illegible] mitted by the Division. This [illegible] vealed in many specific instances [illegible] the data was inaccurate due [illegible] ment malfunction and, in [illegible] ment maintenance and [illegible] the Division were [illegible] able so as to make the validity [illegible] doubtful. Therefore, [illegible] able data and the lack of [illegible] the emission limits proposed [illegible] 1972 were not finalized. Instead [illegible] tablished a monitoring network [illegible] lected air quality data at 23 [illegible] vicinity of the seven copper [illegible] located in Arizona. Data [illegible] from these sites during the [illegible] tween June 1973 and October 19[illegible]

The operator of each of [illegible] Copper smelters a[illegible] smelter is as follows [illegible] Tucson Intrastate [illegible]

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
- - - - - - - - - - - - - - - - - - - - - - x

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO., :

Plaintiffs, :

- against - :

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION, JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION, :

Defendants.
- - - - - - - - - - - - - - - - - - - - - - x

MEMORANDUM OPINION AND ORDER

76 Civ. 5124

KNAPP, D.J.

At a hearing November 23, 1976 the court denied a temporary restraining order on the ground that plaintiffs had failed to show that anything scheduled to happen before December 10, 1976, the date of the hearing on the preliminary injunction, could cause it irreparable injury.

On the renewed motion for a temporary restraining order argued December 3, 1976, counsel made many vague statements leading to the conclusion that plaintiffs would be "put out of business" before a hearing could be held. However, careful study of the several affidavits dated December 2, 1976, which were submitted in support of the renewed application, disclose that none of them set forth a single evidentiary fact to establish such conclusion.

The temporary restraining order is, accordingly, denied.

SO ORDERED.

Dated: New York, New York

December 6, 1976.

WHITMAN KNAPP, U.S.D.J.

A-719

LETTER OF NEW YORK COCOA EXCHANGE

127 JOHN STREET, NEW YORK, N.Y. 10038
CABLE ADDRESS: "COCOCHANGE"

TELEPHONES:
(212) 269-0500-1
Secretary: (212) 422 5905

March 5, 1976

Commodity Futures Trading Commission
1120 Connecticut Avenue, N. W.
Washington, D. C. 20036

Attention: CCU

Subject: Commodity Options

Gentlemen:

As you are aware, the New York Cocoa Exchange is definitely in favor of commodity options trading. Our views were detailed in the position paper of the Exchange which accompanied our letter of December 9, 1975 to Ms. Margaret Harrison, The Advisory Committee on Market Instruments, Commodity Options Subcommittee, which included our opinions on the subjects listed in the summarized agenda for the meeting which was held on Monday, December 15, 1975. A copy of our letter to Ms. Harrison and the position paper referred to are enclosed for your ready reference.

With respect to your request for comments relating to Part 32--Regulation of Commodity Option Transactions Registration; Fraud, we wish to make the following brief points that we recommend you carefully consider before granting permission for trading in commodity options as outlined.

1. The New York Cocoa Exchange, Inc. is strongly opposed to permitting option trading through other than registered Futures Commission Merchants on recognized contract markets. The New York Cocoa Exchange, as well as other contract markets, have preliminarily drafted rules and regulations governing implementation of option trading through registered Futures Commission Merchants requiring original margin deposits, variation margins, etc. to be

paid to a Clearing Association. It is evident that such precautionary measures will provide the proper safeguards to the public participating in option trading. If the CFTC permits private dealers with a net working capital of $100,000 to deal in commodity options on other than recognized contract markets and through registered Futures Commission Merchants, we are greatly concerned this may lead to the same abuses of the public that were uncovered several years ago.

2. It is quite apparent that if the same commodity options are traded through registered futures commission merchants on recognized contract markets where original and variation margin deposits are required to be paid and regularly maintained, and also permitted to be traded by private dealers with a net working capital of $100,000, the latter will have a tremendous advantage and be able to offer the same options to the public for a smaller premium inasmuch as they will not be depositing margins, etc. However, the public buyers of options through such private dealers will clearly not have the same safeguards and protection afforded by the trading in options on recognized contract markets.

3. We do not consider a net working capital of $100,000 as sufficient funds for a firm to deal in options. One need only look at the volatile price fluctuations in most commodities to realize that $100,000 would be insufficient capital if some difficult market situations were to arise.

4. We believe all premiums paid by the buyers of options should be placed in a segregated account the same as margin remittances in order to provide the maximum protection for the public. In fact, it might be advisable to place such funds in an escrow account to provide greater protection to public buyers of options.

5. It should be pointed out that there is no guaranteed foolproof way to hedge options. The buyer's risk, of course, is limited to the amount of the premium initially paid. He is spared margin calls, variations, etc. unless he eventually exercises the option, at which time he would be required to put up full original margins, etc. On the other hand, the grantor of the option cannot fully hedge himself. If he grants a call option at a specific striking price and buys a futures contract on a recognized contract market against it simultaneously, this would protect him against a possible eventual rise in the market. However, if the market were to decline, the call

option would never be exercised and the grantor of the option would still find himself long one contract he bought on the Exchange as a "hedge". The same is true in the granting of put options or double options. The risks in granting options are highly volatile and this is why we feel strongly that option trading should only be permitted on recognized contract markets through registered commission merchants. Grantors of options are usually professional trade and industry participants in a futures market as it is a rather high-risk operation.

6. The method described for calculating options granted to the market close every day seems extremely complicated, and in our opinion would require extensive record-keeping on the part of the option dealer, not to mention the difficulty in policing this type of record-keeping.

The above are several of the key points in Part 32 that we feel require careful study. We have therefore confined our comments to these points only. Undoubtedly, there are many other points in Part 32 that require further consideration, but due to a lack of sufficient time to thoroughly study all aspects of Part 32 we are unable to comment on other items at this time.

Before closing, we again wish to stress most emphatically that we believe option trading should be permitted, but traded only through registered Futures Commission Merchants on recognized contract markets whose rules and regulations provide the appropriate protection for public participation in option trading.

Thanking you for your kind consideration, we are

Yours very truly,

T. P. Aitken
President

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encls.

## LETTER OF MAC DONALD, KRIEGER & BOWYE

2-722

MacDonald, Krieger & Bowyer
Incorporated
Investment Banking/Member, New York Stock Exchange
356 N. Camden Drive, Beverly Hills, California 90210/(213) 278-7800

March 31, 1976

Commodity Futures Trading Commission
1120 Connecticut Avenue North West
Washington, D. C. 20036

Attention: Correspondent Control Unit

Subject: Comments on proposed rules with regard to commodity options dealers

Gentlemen:

I was told by Mr. Pat Nicollette that even though my letter may be arriving after your cut-off date of March 31 for comments regarding the above that you would be happy to hear from me. My opinions are expressed as an individual who has been trading commodity futures since 1959, both as an investor, registered representative, and officer of a New York Stock Exchange firm.

Reference is made to pages of your Release No. 126-76

A. Page 12, Regarding Segregation of Premiums Received: I believe premiums received should be in an escrow account or a similar vehicle only to be released when the said options are exercised or expired. This I feel gives an added protection of the public's funds.

B. Page 13, Regarding Exemptions of Less than 10 Persons: In order that a pool operator or general partner of a limited partnership not be defined as one person, exemptions should state not to include the above.

C. Page 17, Regarding Contents of Application: An addition prerequisite should be added whereby the majority of the principals of a firm or individual company can show experience of at least ten years in dealing, advising, management in the commodity futures field. This, I believe, is a must to protect the public from the inexperienced layman or through not qualifying to enter this field.

D. Page 26, Definition of Cover: Should mean future contract or physical contract.

It is my opinion that if applicants do meet all the CFTC requirements they should not be confined to trade on regulated commodity option exchanges, thereby enhancing fair competitive trading.

I am aware of the CFTC funding situation but find it imperative that option dealers, particularly those capitalized under $500,000, should be policed as often as possible and that all promotional advertising be submitted to a committee (if possible) for a period of fifteen days and, if the submitting company has not heard from this committee by that time, and only then, proceed with said advertising.

I know the problems and misgivings of this business and am fully cognizant of past incidents that occurred at Goldstein, Samuelson & Company, among others, a few years ago here in California.

I am at your disposal for any questions or opinions you may have.

Sincerely,

MACDONALD, KRIEGER & BOWYER

J. Harvey Karp
Senior Vice-President

JHK/dr

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AFTERNOON SESSION

(2:00 p.m.)

CHAIRMAN RAINBOLT: Our last scheduled witness this afternoon is Mr. Charles Hecht of the British-American Option Corporation.

MR. HECHT: I'm Mr. Hecht. I'm special counsel to British-American Option Corporation, and with me is John Loewey, who's also an attorney for the corporation.

CHAIRMAN RAINBOLT: Thank you. We'd be pleased to hear from you at this time.

MR. HECHT: Firstly, I'd like apologize to the subcommittee. I was just called in last week, and in going over these proposed regulations I have certain preliminary comments. And I intend to, within five days, file a written summary of this with the Committee and if there are any extra copies that people want, I'll file enough additional copies so that the persons can obtain the same from the subcommittee.

CHAIRMAN RAINBOLT: Okay. Without objection, I'll make your formal presentation follow your oral presentation to us at this point in the record so it will be printed up in that manner. Thank you.

MR. HECHT: Thank you. I appreciate that.

I should start off by stating that at the present time British-American is not registered with the Commission.

However, we did advise the staff, last week, that prior to the end of this week we will be filing a registration statement as a commodity trading advisor.

Of course, I understand that under the regulatory scheme that this is, in effect, a provisionary stop-gap solution until these regs, with respect to the commodity options dealers, come into effect. Generally I would like to point out that the use of commodity options, or so-called "London Options", which my client deals with is a relatively new investing device in this country.

And both the industry and the concerned government regulatory agencies have limited experience with this area, which is extremely complex. It is my understanding that at the present time only the International Commodities Clearing House, and the London Metals Exchange, in London, England, make available so-called--quote "guaranteed" end of quote -- options.

In that every option sold by a clearing member of the ICCH, or the London Metal Exchange is registered both as to the option, and the underlying futures contract. So that the option is directly traceable to a finite and particular futures contract.

With that in mind, and because of certain proposals in your regulations, I forwarded to the ICCH a copy of your proposed regulations, and a copy of the staff's explanation.

I feel that these two -- I'm going to put in quotes "exchanges" again -- because there may be some question of whether or not they are recognized as an exchange -- have a legitimate interest in your proposed regulations.

And it's my understanding that as presently structured, they would not come within the definition of what is a registered trading market with you, unless they consented to your jurisdiction. That's a question, really, between you and them, but my client does have an interest because whatever the results are of your discussions with those associations or clearing houses, would have a direct effect and bearing on my client; and other people who deal in so-called, London Commodity Options.

One suggestion, I would suggest to the Committee to consider is to work out an exception to the definition of a registered trading market for such associations as the London Metal Exchange, or the International Commodities Clearing House, to the extent that they are recognized markets in their countries.

That's something I don't think you can pass on lightly, but I think it's a suggestion that's worth pursuing and looking into. The next specific area is the minimum net working capital requirement of $100,000.

And in particular, I'm talking about Section 32.2 of the proposed regulations. It should be noted that the

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the regulation is presently drafted, there is no distinction between the option dealer, who sells options only, and does not take an equity position in the market, vis-a-vis, an option dealer who trades against, or with his customer.

In the former situation, my client's method of operation is that basically he sells the option to a customer. The option is written through a member of the International Commodities Clearing House, or the London Metal Exchange. The option writer is someone in England, who we do not know.

However, the clearing member, who sells that option in effect to my client, must in effect segregate his funds, and they mark the market every day on those exchanges. To me it's analogous to the situation you have the securities industry where a broker/dealer clears through another house.

There are lower net capital requirements because in this case the broker does not hold the customers funds and is not taking a position either with or against his customer. All they are doing is dealing in options.

When the customer wants to close out an option, they instruct Shearson Hayden and Stone, which is their executing broker, to sell a futures contract to close out the transaction, and then remit the funds to the customer. And whether the customer has a profit, or a loss, would depend on the amount of the funds realized on the sale of the options, and the purchase price for the option.

And I think there should be a basic distinction made between a premium, and a so-called "charge to a customer". And to me it is very unclear in the proposed regulations, what the term "premium" means. To me, a premium has always meant that that is the funds that the writer of the option receives for the privilege of selling either a put or a call against the contract owned by him.

The way it is written in the net capital regulation it is very unclear. What I am saying is, that where a commodities broker/dealer, or a commodities option dealer -- to use your term -- does not take a position in the underlying commodity, the same net capital requirements including the computations do not make sense.

I can see where the commodity dealer goes into the market and buys an option for his own account -- or to use the ABT situation where he covers the transaction with his own trading account. But where the option dealer does not do this, and is in effect just acting as an agent for his customer -- where he doesn't sell on margin and he doesn't hold the customer's funds -- I see no need for going through with such a significant net capital requirement.

I would respectfully suggest to the Committee, and to the CFTC, that in designing this rule an exception be carved out for a commodities option dealer who trades solely as an agent, i.e., one who does not have a beneficial inter

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in the underlying commodities contract; and at the same time does not engage in transactions for his own account, i.e., where he acts strictly for customers, there should be a different net capital requirement because you do not have the same economic need.

As a corollary this type of commodity dealer -- this type of dealer if he was a securities broker/dealer would have a minimum net capital of $5,000. And in certain circumstances it would be reduced to $2,500.

It is my belief that $5,000 is far too little, and that initially the staff should consider a minimum net capital for someone who transacts business solely in this manner of between $25,000 and $40,000. It should be pointed out that once the commodity option dealer gets into a trading situation for his own account, whether it be through options, or through futures contract, or through any other commodity vehicle, then the net capital rules, as applicable to all commodity options dealers should be applicable to that particular dealer.

In this connection, I have asked the accounting firm of Katz Zuckerman and Company, which is the special accounting firm for British-American, to submit in writing its detailed comments with respect to the operational and mechanical aspects of the net capital rule.

The next set of comments refer specifically to

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Section 32.5(4)(5) and (6). It is my belief that as presently drafted these sections violate various provisions of state and federal law. There is a basic distinction between a regulatio of a commodity dealer, and the concept of doing business within a state.

I know it is the CFT's position that the former, the so-called regulation of the commodities broker/dealer is exclusively within their jurisdiction subject to certain contentions of the SEC. And there's a recent case that came down, that Clayton Brokerage Co., of St. Louis v. Mauer, which I'm sure General Counsel is familiar with, where the Supreme Court of Texas took the position that the regulation somewhat involved in commodities futures is exclusively a federal matter.

However, the concept of what is doing business within a particular state is clearly a matter of state concern. What these regulations require is that the commodity options dealer register in every state he transacts business, or proposes to transact business, or offers any commodity option.

Now, the question of whether or not he is subject to suit in that particular state is a matter of state concern. And I think in that situation the way you now have it done, the states can back in and say, "Well, look your own regulations have created a dual regulation on these people".

And I think that there should be a clear distinction

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made. You also have a very practical problem in that this requirement will put in a cost of doing business of approximately $10,000 a year for each commodity options dealer, because he's going to have to register in every state where he feels he could potentially do business when there is really no justification for it.

You have jurisdiction to regulate. If it's a matter between the customer and the commodity options dealer, he pursue either remedy. He can begin a suit in state court, or he can begin a suit in federal court and allege jurisdiction under your broadly based jurisdictional statute. But I just don't see any legal requirement, or practical requirement for forcing each commodity options dealer to register in each state and then appoint an agent for service.

The next particular area is Section 32.5(7)(c) et cetera, the next four sections. It's my opinion that certain portions of these sections are not permitted under your statutory language set forth in Section 4(n)(7)(b)(ii). In that there is a basic distinction recognized in the statute between an administrative hearing, and an order of permanent injunction by a court of competent jurisdiction.

Although this basic distinction is recognized in the statute, the proposed regulation does not recognize such distinction. And I believe it is so basic to the statute that I respectfully suggest that the proposed regulations be

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amended.

In the statute, in specifics, there is nothing in the statute which refers to administrative proceedings. It refers to a court of competent jurisdiction. In addition, y have a felony, or a misdemeanor.

And I believe that there is -- that th [illegible] the regulations are proposed you misunderstand the [illegible] asic nature of what is an administrative proceeding, and in particular what is an administrative proceeding before the Securities and Exchange Commission.

I also note in there that the way the regulation is drafted this includes consent decrees entered into by a control person, or an affiliate of a commodity options dealer who wants to register. Now, a consent decree, at least at the SEC, has two key provisions in it, everyone that I've handled.

One is, it says it solely for the purpose of this proceeding. The second is that the person consents to the order without admitting or denying the SEC allegation. The way your registration rules are presently drafted, you are giving a retroactive punitive effect to a consent decree that may have been entered into five years ago before this agency was ever created.

It's clearly something that the average person did not have in mind when they signed this consent decree.

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Furthermore, I think there's a basic governmental policy of encouraging settlement of administrative proceedings. And if your regulations were put into effect, as presently worded, the effect on proposed settlement of administrative proceedings instituted by other agencies could be dramatic.

Another area is subsection G, which it is this writer's belief should also be deleted. That section says, that if a person was employed by, or affiliated with, anyone who went bankrupt, or a company that went bankrupt, it must be so disclosed on the registration form.

I don't not admit to be an expert in the federal bankruptcy laws. However, it is my understanding that the basic purpose of adopting these statutes was the rehabilitation of honest debtors.

What this regulation does, is it puts a stigma on someone who may have been indirectly involved with a company that went bankrupt ten years ago. Section 32.8, you have in here a very detailed method of doing business disclosure requirements.

I have no objection per se to this type of approach, but I would like to point out to this Committee, and as suggested by the president of COMEX, that the SEC as well as you have a very, very broad anti-fraud rule. And instead of trying to prospectively regulate this type of conduct, there are other alternatives than proposing rules and regulations which may be far too detailed to work with.

For instance, you have a requirement, people are to furnish to you their so-called marketing literature. And the question comes up -- and it's a two edged sword -- that if they submit this material to you, they can ultimately use this material and say, "Well, we filed it with the CFTC, so how can you as a customer complain".

The second side of the sword is that the marketing material in and of itself may not be misleading. But when it's combined with certain oral representations, the two together can mean a fraudulent course of conduct. My suggestion would be that you have the anti-fraud rule, it is very very broadly drafted; and that a better approach would be for the staff to periodically issue interpretative releases on situations that may have come to their attention either hypothetically, or actually, setting forth what they consider to be a fraudulent, or deceptive practice.

In this way, I think you could -- both the industry and the staff could work with it. It also has the added benefit that such releases could be utilized in court in any action brought by the staff. Similarly it could also be used by the consumer.

At the same time, it wouldn't tie everyone down to a rigid set of rules in an industry that we all have somewhat a familiarity with. One comment I should have addressed

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myself to earlier is that someone said that because they have this kind of filing down in Washington, does not mean that the people are going to come down here and read it.

Well, my point is: Look, as long as you disclose it, then it's up to the consumer, if he's so interested, to come down to Washington and review it.

I have some specific detail suggestions which I will put in my letter, proposed revisions to your so-called description of business section. I should point out that I think that what is important to the consumer is what happens to his option in case the commodity option dealer goes bankrupt, goes out of business.

I think that's a concern that you have all expressed today with various speakers. Two alternatives, I think, should be looked into which have not been discussed. One I'll address to the General Counsel, has anyone looked into the situation of coordinating this with the Securities Investors Protection Corporation, because I think commodity options would clearly be deemed a security?

And irrespective of your jurisdictional disputes with the SEC, one possible avenue for protection may be that SIPC would have jurisdiction in this area.

The second alternative is that, when someone operates line British-American, they set up an omnibus account through Shearson Hayden. If, in fact, something

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should happen to British-American, the trustee who comes in, or the federal agency would have immediate access to the omnibus records, which are kept on a daily basis.

Now, those omnibus records correlate, by number, the option number with the option registered on the applicable London Exchange. In this way, you could immediately trace whose the option was. What option Mr. Jones owned, what option Mr. Smith own. Then if the customer wanted to exercise the option, they would not have to go through British-American but could go directly through Shearson Hayden, who had the omnibus account. And in this way the customer would be protected.

And I'm sure something can be provided that in the event a commodities option dealer -- assuming he applies with the applicable net capital rules, but it happens, something goes wrong -- you have SEC firms going out of business every day as we are all aware of -- that a mechanism could be devised where your agency, or an appropriate trustee, could immediately step in -- and the key document to get a hold of is that omnibus account, because once you have that, you can trace every particular option and the customer's protected.

Another proposed area of regulation is disclosure to the customer, not only of the premium he's paying, but of on what basis the broker charges a commission. To me, this analogous to the situation where a broker sells the

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over-the-counter stock as principal to his client and the amount of the profit to the broker is never disclosed.

In our situation was have a unique problem, in that the commodity options are a relatively new industry. Therefore, the newspapers and the financial reporting services have not picked up, or do not now publish quoted prices with respect to various options, like in 90-day option in sugar with a striking price at 32.

The only alternative the consumer has is that he has to call up three or four houses to find out what the price is for a particular option, but this is a factor of competition. And assuming, as everyone here has done today, that this aspect of the industry is going to grow, it is going to get more competitive.

And to the extent that there are certain dealers who may be over charging for their services, as a fact of competition, the other dealers should be able to drive them out. Now, I can't force the New York Times to publish tables on the prices of commodity options. But if there's enough demand for it, the papers will publish it.

And the classic case is the old put and call options. Five years ago you couldn't ever find a quote on the put and call options. All you had were ads in the Wall Street Journal by Filler, Pullard and Schmidt, and a few other houses; and you looked at the paper, and you looked at

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the options, and said,"Okay, that's the option I want, and that's what I'm willing to pay".

I have seen todate, very little advertising by the so-called commodity option dealers, but I think that this is the thing to come. I think you are going to see advertisements in the financial papers advertising certain options at a specified price.

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I have a number of minor points, which I will cover in my letter, but I wanted to cover a few of them here briefly. You have a requirement that the broker/dealer, or the commodity options dealer is to renew his application annually.

On the other hand, you have a requirement under the preceding section that you must promptly amend their applications. I think it is somewhat redundant. If you've got an obligation to amend his application, to keep it current, I don't see any need in making him re-register again, except for an additional filing fee.

The point is, you have jurisdiction, he is subject to your regulations, and it's the dealers obligation to keep his application current. Another thing, I noticed this morning there was a comment with respect to the trading of commodity options on margin.

To me, the whole concept of the commodity options is that the consumer knows that when he invests his 1,000 dollars, or 1,500, or 700 dollars in an option, that is his

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risk. In short, whether the commodity -- underlying commodity, doubles or triples in price, or whether it falls to the floor, his risk of loss is $800. That's his price of admission, and he knows his price of admission.

Where you do a commodity options on a margin basis, in effect, you almost have what I call a futures future. And you have all the problems inherent in buying the commodity. In this connection I should point out, that I have served in the past as an AA arbitrator.

And the number of suits I've seen where the customer has been hit with a margin call, and says to the brokerage house, "I didn't know what I was getting into" -- and they go to arbitration because brokerage house has it -- has an arbitration clause; and they sue the customer for $30,000, $40,000.

And I'm surprised as an arbitrator how someone -- how any brokerage house, or commodities dealer could permit someone to start trading in commodities with an account of $5,000 or $10,000 buying something on very low margin. That is where the so-called "little man" has really been hurt. And I think it's a fact everyone's overlooked.

Yes. It's in the interest of the traditional broker/dealer to sell commodities on margin. Someone has to offer a vehicle where the small man, or the small business man is not subject to this kind of risk. He should be able

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to say, "Okay, I put my money in, that's it. If that's what I lose, that's what I lose", and know where his downside risk is.

And the big houses haven't done it because they have their reasons. And that's why you have really a relatively infant industry with a limited number of persons now selling these options. I think they have a future.

Yes. Regulation is here. I think it is something we all have to recognize. But I think it's something that should be worked out very carefully so you don't kill an infant industry before it has a chance to either prove itself, or disprove itself. Thank you very much.

CHAIRMAN RAINBOLT: Thank you for your comments. We appreciate receiving them. I don't think the issue is whether or we're trying to over regulate an infant industry that produced Goldstein-Samuelson three or four years ago. I don't think that's really the question here.

And I think if you'll pursue it with me, why, you'll see that that's not the question. I'm intrigued by your concept that London Options are guaranteed.

MR. HECHT: I put that guaranteed in quotes. Obviously I can't guarantee that you are going to make money on it, or something like that.

CHAIRMAN RAINBOLT: I see. Well, they can't -- there's a lot that they can't do with the so-called guarantee

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on the London Option. For example, are you saying that if your company goes bust, that the customers that has got money with you will be guaranteed that he will be -- he will receive some payments in the form of compensation for --

MR. HECHT: No. What I'm saying --

CHAIRMAN RAINBOLT: -- for the premium that he put in?

MR. HECHT: -- what I am saying, guarantee, it's guaranteed to the extent that when and if the customer wants to exercise his option, either -- you know -- by closing out the other side of the transaction -- there is a specifically identifiable underlying commodity contract to deliver to him, or to exercise against.

What you're afraid of, and I think what made Goldstein-Samuelson such a bad situation, is that these gentlemen were writing so-called "naked options". They were taking the customer's money. They were telling them, we bought you an option on the London Exchange, and they never bought the option.

So if the customer had a profit, he had no way to get his profit out; and if he had a loss, well, he had a loss any way. That's not the situation with London Options.

What I'm saying is that the underlying contract is there so that when, and if, the investor -- or consumer -- wants to exercise his option, what happens is Shearson Hayden

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Stone will then sell a futures contract to close out the underlying contract, and the customer either has a profit or loss. It's handled as a net transaction as I understand it.

CHAIRMAN RAINBOLT: I'm not sure it works exactly that way, but let me explore this with you. The International Commodities Clearing House -- let's take for a moment the problem of the soft options -- ICCH provides for a form of backing, and I think that's probably what you're basing the requirement on.

Now, I assume that your client goes through Shearson, is that the way it works?

MR. HECHT: Yes, it does.

CHAIRMAN RAINBOLT: And Shearson is a member of ICCH, is that correct?

MR. HECHT: I don't know if they're technically a member. They have an affiliate over, I understand.

CHAIRMAN RAINBOLT: I see.

MR. HECHT: Mike Siegel is over there, from Shearson, and I think he's coming back today.

CHAIRMAN RAINBOLT: Understand, of course, I'm not quarreling with the entities that are involved, whether Shearson is reputable brokerage firm, or your client where involved. But let's take that as a hypothetical situation for a moment.

If ICCH goes bust, of course, there's really no

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guarantee at all that a customer of your client's will receive their option. But more than that, suppose Shearson goes broke, what does that -- what happens in that event?

MR. HECHT: Well, if Shearson goes broke -- one of the reasons we have someone over there now is to check out what happens in the event Shearson goes under. Since they are the executing broker, we would be able to get a record, and we require, since I've come in, on a daily basis a record of our omnibus account.

So that if anything should happen to Shearson, we have some protection. And it just so happens that in the last couple of weeks there are a couple of transactions that Shearson has not executed correctly, or has lost track of. And through that omnibus records, we have been able to trace the underlying commodity and clean it up.

CHAIRMAN RAINBOLT: Suppose your client goes broke, what happens to the customer's money?

MR. HECHT: Okay. Well, now the customer's money goes three ways. A portion of it goes for the premium to the option writer in London. A portion of it goes to Shearson as a commission for executing the order. And a portion goes to my client for a commission for obtaining the sale.

CHAIRMAN RAINBOLT: Is that -- All right. Now --

MR. HECHT: Okay. That's why the way the regs are drawn it's very unclear what is quote a premium.

CHAIRMAN RAINBOLT: I see. Well, my questions really goes to what happens if your client goes broke, what happens to the customer's funds that he paid in?

MR. HECHT: Well, the funds have been disbursed to three separate entities.

CHAIRMAN RAINBOLT: The customer is out of luck?

MR. HECHT: No. He's still got his option if he want to exercise his option. Then the Shearson -- my client keeps a daily omnibus account, that's how it's handled at Shearson in a technical way. That omnibus account discloses the registered number of the underlying contract right on the omnibus account.

So if there were any problems, you could have someone from your staff up there the next day and you could trace Mr. Jones' specific contract.

CHAIRMAN RAINBOLT: So if you go -- if your client goes down -- we all assume that that will not be the case, I'm only assuming --

MR. HECHT: Well, let's assume that it would because that's what I think you are looking for.

CHAIRMAN RAINBOLT: Let's assume that your client goes down, and I am an options customer, and I've paid money in. And my option has made a profit, I know, because you told me before you went broke that my option made a profit. How am I going to get that profit back? So you've gone under --

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MR. HECHT: You can go --

CHAIRMAN RAINBOLT: -- you've got all kinds of creditors over you.

MR. HECHT: Well, we've worked it out with Shearson, you can go directly through Shearson to close that out.

CHAIRMAN RAINBOLT: I would go directly through Shearson?

MR. HECHT: Yes.

CHAIRMAN RAINBOLT: Who guarantees that?

MR. HECHT: Who guarantee -- well, that is not clear. My understanding, from my client, is that Shearson guarantees that right. But until I see it in writing, I'm not so sure,and I won't represent to you that they do.

CHAIRMAN RAINBOLT: Now, let's take the problem of the London Metals Exchange, let's say. What do you represent to your customers there?

MR. HECHT: What do my clients represent to their customers?

CHAIRMAN RAINBOLT: Yes.

MR. HECHT: It's -- I understand, of course, you can't monitor every sale, and every minute of the day, but I think that they advise their customers -- if the customer wants to know who we clear through, we tell them Shearson Hayden Stone.

CHAIRMAN RAINBOLT: And do you tell him that they are guarantee to him?

MR. HECHT: No. We tell them -- you tell -- the way I understand it, you don't tell them they are, quote "guaranteed". What they are saying is, that there is an underlying option -- underlying contract in London. So that if and when you want to exercise the contract, or your option, that it will be -- you can exercise it.

As a matter of fact, London marks up, I understand marks the market on a daily basis the clearing house member.

CHAIRMAN RAINBOLT: Then you look to Shearson to honor that guarantee, right? As far as your client is concerned, he would look to Shearson to honor the agreement that obviously they had entered into?

MR. HECHT: Well, I think the client would look to my client first. And if we have any problem, then we would go put some pressure on Shearson.

CHAIRMAN RAINBOLT: On Shearson. And then once it disappears to Shearson, you don't really know what happens to it, do you?

MR. HECHT: No. We get a daily run from them on their execution.

CHAIRMAN RAINBOLT: Well, I thought you said you weren't sure whether or not Shearson was a member of the clearing house, itself.

MR. HECHT: Well, I don't know if they are a member,

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they have an affiliated relationship with a member. I haven't seen if they are a member yet, but I know they have an arrangement with them.

CHAIRMAN RAINBOLT: I suppose that they are. Yes. My recollection is that they are, though I could be wrong.

COMMISSIONER DUNN: They are a member. Whether or not they are principals, I --

MR. HECHT: Right. I don't know if they are principals -- they're an affiliated member, but I don't know -- the key person is the clearing house member that has the options sold through him; that's the fellow you really want to get.

CHAIRMAN RAINBOLT: You see, Mr. Hecht, the problem -- the problem is not -- is really that the guarantee at ICCH only runs to the principals that are involved. And if Shearson was the principal, fine it runs to Shearson. It does not run to your client. And, therefore, it is not guaranteed to your client.

And certainly from that term, assuming that your client can only guarantee to the ultimate customer whatever he can pass along, you know there is no guarantee to the ultimate customer. This is as opposed to a situation such as on COMEX, or at the Chicago Mercantile Exchange where guarantees do run to the ultimate customer.

I'm not holding that out, because not all U. S.

exchanges have the guarantee to the ultimate customer, usually they'll come down to the member itself.

MR. HECHT: Well, one of the things we are working out now, and one of the persons involved with British-American is over in London, and they -- to work out the possibility of becoming a member so the guarantee can run directly.

CHAIRMAN RAINBOLT: I understand. Someone told me once that it takes only a very limited amount of capital to become a member of ICCH, and that's part of the problem.

MR. HECHT: No. Our understanding was, they want a bond at 1.2 million dollars. I don't call that limited.

CHAIRMAN RAINBOLT: That's pleasant to hear, because our initial understanding was that they were far less than that.

MR. HECHT: No. They are looking for a bond of about 1.2 million. And, of course, the English don't have the same concept of net capital, or net working capital, that we do. All they want to know is, you're bonded so you can cover so much.

CHAIRMAN RAINBOLT: At any rate, at the present time -- I'm not trying to engage in an advocacy here, but at the present time I think you would agree with me, that as far as whether or not the ultimate legal rights of a customer to invest in your client's operation -- and in the

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event that your client's operation doesn't belly-up -- he is not exactly in the hundred percent -- in the par situation that a regulated commodity customer,under the Commodity Futures Trading Commission, investing in a regulated futures contract would have, isn't that correct?

MR. HECHT: Well, basically yes. I would point out that the customer is not investing in my client, he's investing in London Options.

CHAIRMAN RAINBOLT: The customer's -- the London Metals Exchange is an interesting thing. I only bring it up because you brought it up. Do you know who backs London Metals Exchange operations?

MR. HECHT: No. I know that my client is considering going into this London Metals Exchange, but primarily has been dealing with so-called soft commodites.

CHAIRMAN RAINBOLT: I see. They are not in London Metals?

MR. HECHT: It's my understanding that, as of today, they are not; but I know they are considering it.

CHAIRMAN RAINBOLT: They are not. Okay. I misunderstood you, because I thought that you said that they were. You've indicated to us some interesting aspects of doing business there.

Let me ask you this. The -- when --

MR. HECHT: Can I give you an analogy? I know in

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the SEC broker/dealer forms, and the SEC Investment Advisors Act, there is no requirement that you must file with every state, et cetera.

Of course, if you have an office in a state -- I mean you are obviously doing business there -- yes, then it's the corporation's job to register there; but that's really a question of state law, I feel.

CHAIRMAN RAINBOLT: Let me ask you this. The issue of segregation is one that intrigues us primarily because when you get into the options area it becomes increasingly difficult to come up with a [illegible] protection device that provides total protection to the customer.

Now, along the line that we -- that the industry seeks to protect futures contract customers -- for example, now, that premium that the customer pays in, is it split up into three -- it is really --

MR. HECHT: Well, in the practical economic sense -- I'm getting away from the statue -- when you are talking dollars and cents, the person who is selling the option is getting a premium for that option, and of course calls.

In addition, the house that is selling them is not a charitable organization, they are charging a commission for their services. In my client's situation, there is also an executing commission through -- paid to Shearson Hayden Stone for executing -- handling the execution of the transaction,

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and a lot of the bookkeeping.

CHAIRMAN RAINBOLT: In the commodities business, the money that would paid in would be kept in a segregated account by the FCM for use of their customer. In your circumstances -- in your client's circumstances, that's not exactly the case is it?

You indicate that part of it comes in, and that's goes as income to your client, part is passed onto Shearson-- and I assume that's a commission and an income to them -- and part goes to London, is that correct--

MR. HECHT: Well, that goes to the option writer.

CHAIRMAN RAINBOLT: -- where it goes to margin the contract? In any event -- now, of course, we have no jurisdiction over London at this time. I guess we have jurisdiction over your client, and over Shearson.

But I still get back to the point that I raised with you earlier, I fail to see what guarantee is there, that in the event your client goes broke, that there is an adequate device there to protect not only the premium that he paid in -- and assume his option is in the money for the profits that he's received -- can you shed some light on how that should be handled, how that we should approach that problem?

MR. HECHT: Well, my approach is -- and I think we've all seen the problem here, today, whether it's SIPC, or whether it's under traditional bankrupcy laws. As a practical matter,

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my client maintains a special omnibus account at Shearson Hayden Stone which sets forth every option held for its clients, by name, including the option number, which has, of course, a corresponding number on the underlying contract in London.

So if the customer wanted to exercise his option -- I think "guarantee" in a way is a misleading term --

CHAIRMAN RAINBOLT: I think it is too.

MR. HECHT: Okay. If the customer wanted to exercise his option, then we know what option it is, and then either Shearson could do it, or whoever the trustee appointed to close out the transaction.

CHAIRMAN RAINBOLT: You indicated that you think $2,500 to $5,000 is too little for a captial requirement, and you suggest a figure of $25,000 to $40,000, how dc you arrive at that figure?

MR. HECHT: Well, I looked at it this way. I think that this is a new area. I think that the Securities and Exchange Commission had a prior history where they saw, under certain limited situations, some would only require $5,000 capital if their business is handled a certain way.

I think because of the newness of the area, you want to discourage so-called marginal operators, with marginal capital. And yet, I don't see the need for $100,000 net capital. Because your $100,000 in net working captial, the

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way it's presently worded, the more business my client does and the better his customers do, the more he is charged -- the more the charges are to net working capital.

In effect, you are almost hoping that the customer does poorly. This way you have no problem with your net working capital, the way it's presently drafted; and the accountant will point that out in detail.

Because if it's a call option, and it goes up, you keep charging your account for each cent that goes above the striking price in your relative percentage. So I told my client that the way it's presently worded, I can't see how anyone would get in the business with less than a quarter of a million dollars.

CHAIRMAN RAINBOLT: Commissioner Dunn?

COMMISSIONER DUNN: You've asked a number of my questions. I'm sorry I didn't get here in the beginning when you were introducing yourself. I gather that you are counsel for British-American?

MR. HECHT: Yes. I'm special counsel for them, Commissioner.

COMMISSIONER DUNN: And that is an American company?

MR. HECHT: Yes, it is. It's -- I believe it's incorporated in New York

COMMISSIONER DUNN: Okay. Does the company engage in activities other than options?

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MR. HECHT: Yes. It's my understanding that's all they do now.

COMMISSIONER DUNN: I see.

MR. HECHT: And basically all of them are through the London markets -- London -- the ICCH.

COMMISSIONER DUNN: It does not act as a futures commission base?

MR. HECHT: Not as that term is defined, no. And they don't take a position.

COMMISSIONER DUNN: It's not a registered futures commission merchant, or trading advisor?

MR. HECHT: Well, I explained in my opening remarks that we advised the staff, last week, that we were going to register as a CTA, and we hope to have the application in this week.

COMMISSIONER DUNN: I see. Is the company a member of any of the designated contract markets, exchanges in this country?

MR. HECHT: As of now, I understand it is not because they've been dealing exclusively in so-called London Options.

COMMISSIONER DUNN: Okay. Which commodities, especially?

MR. HECHT: I looked at some of their records, there was coffee, sugar -- coffee and sugar, I think are the two primary ones.

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MR. SCHNEIDER: Cocoa?

MR. HECHT: I don't know if they've done much -- I know they've done a lot in coffee and sugar, maybe cocoa too.

COMMISSIONER DUNN: You have heard the proposals for trading these options on organized exchanges in this country, are you in a position to comment on that proposal?

MR. HECHT: Well, as far as the jursidictional question, I think we could both write brief on whether or not you have jurisdiction over the London people. My clients, as a matter of record, have no formal objection to trading through a U. S. trading market.

The problem is that the London markets have developed a better vehicle, at this time, and the consumers -- from the consumer point of view -- the consumer is much happier with the London market, and is much more sophisticated, and much more developed in this area.

That you can trace it, they have the same devices that you're proposing. They mark the market every day. The clearing member segregates out funds as the -- at the end of the market to reflect the price changes in the underlying commodity.

COMMISSIONER DUNN: At the moment this may be true. But this gets me to the next question, which is true, Dr. Rainbolt's been asking, and that is its relationship with

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Shearson, and the writer of the options.

When you talk about omnibus accounts, I'm not entirely clear as to how you -- what you mean when you use the term, I think you use it a little differently than we have. As I understand, you are placing orders, or let's say selling to the public?

MR. HECHT: Correct.

COMMISSIONER DUNN: And then you transmit these individual, let's say "calls", to Shearson?

MR. HECHT: That's correct.

COMMISSIONER DUNN: Shearson aggregates them, and lays off his position in the market?

MR. HECHT: That's basically right, yes.

COMMISSIONER DUNN: So that in effect Shearson has become a principal?

MR. HECHT: That's right.

COMMISSIONER DUNN: Okay. Now --

MR. HECHT: To a degree -- it depends on -- but Shearson, yes. For purposes of --

COMMISSIONER DUNN: -- but you really are looking to Shearson?

MR. HECHT: Right.

COMMISSIONER DUNN: And I gather that you don't -- from your comment, that you don't really know who, let's say, wrote the option in London?

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MR. HECHT: Well, most of the times we do because we get the prices from them, and they call up -- and on the Reuturs Service they come over, so we know which particular clearing member is writing a particular option.

COMMISSIONER DUNN: A contract which your customer gets, does that show the name of the person who wrote this option in London?

MR. HECHT: No, it does not.

COMMISSIONER DUNN: It shows Shearson?

MR. HECHT: It shows us as a -- it's written as a principal ticket, analogous to a principal ticket in the brokerage industry is how it's confirmed to the customer. Yes. They should revise their forms, their confirmation slips. They know that already.

COMMISSIONER DUNN: Okay. But if your really looking to Shearson -- Shearson, of course, is a member of the brokerage exchanges, and --

MR. HECHT: Right.

COMMISSIONER DUNN: -- it's interesting. It would seem to me that there would be little difference to you, as a seller, whether Shearson was laying off his position in this country, or in London.

MR. HECHT: It doesn't make a difference, really, to us. It's just that if for some reason they feel that because they are traceable -- the particular option is

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traceable to a specific underlying contract that the customer feels much more secure. And Shearson is directed to lay these off in London, or however they handle them. But we do it through a London dealer.

COMMISSIONER DUNN: I think that answers my questions. Thank you.

CHAIRMAN RAINBOLT: Mr. Schneider?

MR. SCHNEIDER: I'd like to pursue this line of questioning that both Commissioner Rainbolt and Commissioner Dunn have taken up with you.

In your view, when a customer comes to British-American, do you believe that the customer looks to British-American as being responsible in the transaction, or does the customer view some entity further down the line as the responsible entity?

MR. HECHT: Well, I don't sit over the salesmen's shoulders -- and I just got called in last week -- it's my understanding, and I haven't been there to physically observe them, however, I do know that voluntarily certain members of your staff of your New York office made periodic visits there and seen their method of operation. On what is said to the customers -- and I really don't know what's in the customers mind, it's a very tough question to answer --

MR. SCHNEIDER: Well, I'm directing this specifically to -- you, at the beginning of your presentation suggested

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that there ought to be an exemption particularly for people trading in ICCH, and LME type options, and suggested that there was not a distinction made between those people that were dealers and those people who were, in effect, the underwriters of the --

MR. HECHT: I think you misunderstood what I said. I said, that there should be a distinction in the net capital rule for those commodity option dealers that take positions, vis-a-vis, in a trading account either with, or against their customers, or on their own; and a commodity option dealer that, in effect, acts strictly as agent in placing orders.

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MR. SCHNEIDER: Right.

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MR. HECHT: Whether it's ICCH, or whether it's the COMEX, or Chicago Mercantile Exchange, really doesn't make a difference in that particular analysis. It's does the commodity options dealer trade either -- any way?

If he does trade, then I can see the computation rule. But if he is not trading in his own account, and is not taking a position in the underlying options, or in corresponding puts and calls, I see no reason for him to sit down every day. Especially in the case of London, which means you have to start at about ten o'clock at night with a full staff making that capital computation.

MR. SCHNEIDER: Then I am confused, because it seems to me at some point later on you made a distinction between the principal and agent situation, and I thought that was what your comment was directed towards.

Are you saying that the sole distinction on the net captial computation ought to be one, vis-a-vis, the situation of whether there is trading for the account of the dealer or not?

MR. HECHT: Yes.

MR. SCHNEIDER: And you are not making a distinction as to whether that person, that option dealer, is dealing as a principal with the customer, or dealing as an agent with the customer?

MR. HECHT: Well, you get some confusion in how you write your particular slip to the customer. Their form slip is very silimar to the old over-the-counter principal slip. But they would have no problem transferring over to a so-called agent slip.

MR. SCHNEIDER: No. The question I'm asking, if I can just pursue this for a second is: Is the distinction that you are making, as to the exemption from the net capital rule, a distinction which is based upon the fact that option dealer trades for his own account, or does not trade for his own account, as opposed to a situation in which he is acting as a principal, or acting as an agent, is that the distinction that's made?

MR. HECHT: I think that's basically correct.

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MR. SCHNEIDER: Okay.

MR. HECHT: What I'm saying is that, when he is trading in the market and taking positions, then he should make these computations because the variation in the underlying commodity price has a direct effect on his assets.

MR. SCHNEIDER: Well, don't you think that someone who is in the market as an underwriter of the option, with a very significant exposure to his customers, ought to have the kind of net capital that we're talking about under these rules? I mean, isn't that the significant distinction?

MR. HECHT: Well, in your definition, would British-American be deemed an underwriter?

MR. SCHNEIDER: Well, that's something I'd like to go to next, if I can.

MR. HECHT: Okay.

MR. SCHNEIDER: But I mean I think that there is very much a distinction between somebody who's acting as a principal in the market, and somebody who's acting as an agent. And as to British-American, itself, I don't think this is the time or the place to get into the specifics as to how it operates.

However, I think that an examination of what the realities of an omnibus account are in London, and in Shearson, would be very revealing. Because I venture to say that the customer of most commodity option dealers believes that he is

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dealing with the person who sells the option to him as the principal. And I think the company often believes it is action only as an agent.

And then when you get into what an omnibus account is, and what the effect of that omnibus account is, I think the line of questioning that Mr. Rainbolt was discussing with you was the line of question which was going to that issue of how one -- if there's a bankruptcy situation, how does one extract what one has either in the market, or by way of premiums, from that omnibus account?

Because, for example, if I'm a customer, and I'm in the money on an option, but there a hundred other customers who are not in the money, and all of that is sitting in an omnibus account, and you go bankrupt -- or the person that sold it to me has gone bankrupt--I doubt very much in an omnibus account whether I can get my specific funds out of that account simply because it is all treated as one account for the account not of the customer, but of the person who was acting the dealer.

MR. HECHT: Well, what they have done here is, they have designed the omnibus account with Shearson so that each particular option is specifically identifiable. They don't state lump position in there from Shearson, they state each particular option within the account; and we get a daily run.

MR. SCHNEIDER: Well, I'd be interested in seeing how that works. And I think that ought to be examined in a great deal of detail.

MR. HECHT: Right. And they've also executed the order individually, Shearson. So there's another duplicate backup record.

MR. SCHNEIDER: You are not -- you're saying that its individual accounts?

MR. HECHT: But it's carried on their books -- and I say this very carefully -- as in effect an omnibus account so we can get a daily run within that omnibus of exactly what the positions of our customers are.

MR. SCHNEIDER: I wonder how a bankruptcy court would view it?

MR. HECHT: I also wonder what the effect of SIPC would be, you know.

MR. SCHNEIDER: Well, I'd like to go to some of those other issues that you raised, and just go through in sort of the order that you went. You seemed to raise an objection to the provisions of the regulation which indicated cooperation with the states.

And I just, in that connection, just want to point out to you Section 12A of the Act, which says, that the Commission may cooperate with any department or agency in the government of any state, territory, district, or possession, or department or agency of political subdivision thereof, or any person.

It does not say in our regulation, nor do I think we could ever effect, a doing business registration. All it merely says is, that you shall designate an agent for service or process within each state.

MR. HECHT: Which in effect means qualifying a certificate to do business in that state to appoint an agent for service, that's what you are, in effect, doing.

MR. SCHNEIDER: All I'm suggesting to you is, that we have a regulatory purpose in cooperation with the states, and I don't think that anything that's been suggested in there is violative of what our Act provides, and anything else like that.

MR. HECHT: Well, I can --

MR. SCHNEIDER: Unless you can point that out to me on that.

MR. HECHT: -- Well, I think it's a state question of quote "What is doing business?" I think if the states have a legitimate interest in a particular commodity options dealer, it's a public record down here in Washington and they can get it just like any member of the public.

And if, in fact, the commodity option dealer is, quote "doing business"as it's defined in that state's law, then that's the commodity options dealer's problem. But I think that's between the commodity options dealer, and the state.

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MR. SCHNEIDER: And you're suggesting that the Commodity Futures Trading Commission has no legitimate interest in seeing that there are state officials who know what is going on within their state, and can work with us cooperatively in an enforcement effort if that is necessary?

MR. HECHT: Not at all. What I am saying is you do have that interest. The way to do it is coordination between you and the state agency.

MR. SCHNEIDER: But not ask the dealer to do that?

MR. HECHT: That's exactly right.

MR. SCHNEIDER: I see.

MR. HECHT: I don't even think you would want the dealer involved in that particular stage. You would want to work closely with the state. And then if and when you were ready to act, then you and the state would figure out who would bring the suit, and where you'd bring the suit.

MR. SCHNEIDER: I was interested in another aspect of your testimony, which related to 32.5 and the reasons why the Commission could deny a registration. I think you quoted from 4N of the Act, which relates to registrations of pool operators and trading advisors.

Are you suggesting that the Commission does not have the authority to create a class of persons who would be registered under our Act aside from the persons specifically mentioned in the Act?

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MR. HECHT: No. I think you do have the authority, but I think the same standards should be set up, and one group shouldn't be discrimated against.

MR. SCHNEIDER: In other words, you are saying that in setting up registration requirements we would have to apply standards which were exactly the same as standards, which had been applied for others?

MR. HECHT: I think you need some uniformity. You can't take out one group and say: Because you had an administrative proceeding with the SEC, we can deny your registration. And yet with another group of people subject to your jurisdiction, have a different set of finite rules.

MR. SCHNEIDER: Are you familiar with the interpretation which we have put out on standards for denials of registrations?

MR. HECHT: Right. You also had a recent hearing on that, I believe, that was just recently written up. But I think it's a little unfair that --

MR. SCHNEIDER: But there is a phraseology in there called "For other good cause shown", which is also in the Act. And I would suggest that we would have authority to determine who ought to be registered with us under circumstances where they are dealing in situations that the public has found highly volatile, that gave rise to Goldstein-Samuelson --

MR. HECHT: Okay. Well, the question --

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MR. SCHNIEDER: -- and so on.

MR. HECHT: -- okay. Well, I think we all know what gave rise to Goldstein-Samuelson. It was really the naked options. Where they were taking the peo 's money, and pocketing it, or doing -- well, you have the same situation I understand in the J. S. Love situation, which you just brought in New York last week.

I'm not saying that it's an area that shouldn't be regulated. What I'm saying is that, if you are going to have a set of standards -- the SEC doesn't have different standards for someone who's a market maker,and someone who underwrites only issues over a million dollars, and someone who underwrites issues only over five million dollars.

What I am saying is, I think you have to have the same standards for the commodity option dealers that you do for any of your other designated groups. And I think it's a little unfair -- and it looks like -- and I'll tell you the people in the industry feel, when they read these regulations, that the Committee, here, had an unfair prejudice against them.

MR. SCHNEIDER: Well, I think if you take the statute, and you take the interpretations of the statutes, you will find that basically the fundamental regulations are exactly the same.

MR. HECHT: No. Let me get a specific -- the

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statute -- I have it marked here (perusing documents). The statute -- I'm going under 7B(2) -- it says --

MR. SCHNEIDER: 7B(2) of what? Of our regulation --

MR. HECHT: Oh, of the statute, the basic -- as it's set forth in the CCH Reporter. Which goes to grounds for denial, suspension, or revocation --

MR. SCHNEIDER: Under -- just quote the section, please?

MR. HECHT: Okay. Page 65 of the Blue Book. If you look at subdivision, under their A, B, and then (1) -- yes. "Convicted of any felony or misdemeanor", that's your statute involving the purchase or sale of a commodity.

Under (2) is "at the time of the issuance of such order" -- we won't get into what the phrase "such order" means -- "is permanently or temporarily enjoined by order, judgment, or decree, of any court of competent jurisdiction".

What you've done in these regulations is, you're saying that, in effect, that an administrative proceeding even where it's consent to by the individual involved -- if he's a controlled person, or an affiliate -- is equal to a court ordered injuction. Just as if he --

MR. SCHNEIDER: Mr. Hecht, I really don't want to belabor the point. But if you go over to page 78 and 79, you have Section 8A, which is also a standard for denial of registration under the Act. And if you look at the bottom of page 78 and the top of page 79, it says that the Commission may deny registration for a number of reasons; and then goes on in (ii) "for other good cause shown", which the Commission has interpreted in connection with this and other types of applications.

MR. HECHT: Well, you --

MR. SCHNEIDER: I understand your point --

MR. HECHT: -- published something in the Federal Register -- I believe, it was last year, you published what you felt constituted good cause shown.

MR. SCHNEIDER: That's correct.

MR. HECHT: But the things that you are citing in this regulation are not the same as what you published in the Federal Register, and that's where I'm having my problem. I mean I think that the staff is always free to publish interpretations of its own statute.

But I think when you are promulgating a rule, you are going one step further. When you have a statute that gives you specified things, and then you promulgate a rule that says: Well, not only those things, but 15 other things -- You have your catch-all for a good cause shown, maybe leave it that way.

But why should these people be singled out for -- because the Hearing Examiner may take the position that the fact that a man consented to an SEC enforcement proceeding

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and agreed to a five-day suspension -- the Hearing Examiner may take the position that's not good cause. It's in a different industry, the alleged violations had nothing to do with the commodities trading, and things like that.

I'd say, leave it. You have your general "for good cause shown", and I just don't think it's fair to this particular group to single them out for 11 different things that aren't mentioned with any other group.

MR. SCHNEIDER: Well, I believe that we ought not to single them out for any kind of different standard. But I submit to you that the standards are going to apply generally the same, and I don't think there is any requirement that they be exactly the same.

MR. HECHT: Well, I don't think they're generally the same. To me, there's a basic distinction in the statute, and this is a matter of administrative law between an administrative proceeding and a federal court, or a state court, injunctive proceeding.

MR. SCHNEIDER: Okay. I really don't think this is the time or place to pursue that.

MR. HECHT: But I'm sure we will -- I think you can understand my distinction. You may disagree with it, but I think you can understand it.

MR. SCHNEIDER: Just on the last area that you had mentioned SIPC, and the availability of SIPC under this because

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I think -- and as you phrased it, you said that a commodity option is basically a security -- I think we, in this Commission particularly, would have a great deal of difficulty in accepting that either definitionally, jurisdictionally, or in any other way.

I doubt whether SIPC would apply. There is a mandate under our statute to review insurance funding of futures transactions, and perhaps this might fall into that area. I don't know where the Commission will come out on that.

But as to your basic question, I would suggest to you that you might want to take a look at Alan Braumburn's recent article in the Corporations Law Journal. I think he quite intelligently and persuasively argued that a commodity option is not a security.

And I'd venture to say if your client feels that it is a security, I think you been have 33 Act registration done pretty quickly.

MR. HECHT: No. But what I am saying, Mr. Schneider, I think what we should all be concerned with is not with the niceties of the statute, but how can we protect the consumer. I mean that's basically what brought this agency in; why you are looking at commodity options.

And I think if there's a sincere interest to protect the consumer, then I think under your mandate, which you have in the statute, that maybe some preliminary coordination should be done with SIPC, since they already have the administration set up, where maybe an insurance arrangement could be worked out with SIPC so that the people are protected in case of a bankruptcy.

I mean, you've got a vehicle there. You may not like it, but I think it's one that should be pursued because we want to protect the consumer. And I'm not saying it's what you have to do, or what you should do, but I think it's something -- I mean that's what we're really all talking about.

What happens in the event of the worse event possible? I think that's what any regulatory agency should gear itself to, so that the public is protected. And if something can be worked out with SIPC, or a SIPC type agency, to protect the consumer so that maybe there is insurance available in the event the member has insufficient net capital -- or in your statute net working capital -- the consumer is protected.

But you've got a different problem here. And the problem is, that these options expire on a certain date; and you must act quickly so that the customer who has a profit in a particular option is in a position to exercise that option before it expires.

And you can have the greatest regulatory scheme in

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in the world, unless you have something where the customer can exercise that option the regulation from the consumer's point of view becomes meaningless.

MR. SCHNEIDER: I appreciate it. Thank you very much.

CHAIRMAN RAINBOLT: Mr. Nicolette, do you have any questions?

MR. NICOLETTE: No.

COMMISSIONER DUNN: I have one. I'd be very much interested in knowing a little about the volume of activity that your company is in on in this whole area. Do you have any information on that, the number of contracts, the number of clients, or something, just to give me an order of magnitude?

MR. HECHT: No. I don't. But I know that the accountant just closed the books to the end of February, and is preparing a net income statement. And I can check with my client.

Do you want the number of options per month, the premium income, or something like? I'm sure we can send it as long as it's consider confidential information until we register under the Commodity Options Dealer's Section.

COMMISSIONER DUNN: Yes. We've been trying to get some understanding as to how many people there are in this business, and what's the volume. There are many indications

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that the interest is growing, but its been difficult to get any precise figures on it.

There is a second question is: How many, if any, have exercised these options? I'm referring here to the merchant class.

MR. HECHT: Well, all I can tell you is, I just wanted to look at their bookkeeping procedures, because I was originally retained last week to check reference -- to design a compliance manual for them. And of the first 25 customers that I look through just at random, about half of them had exercised their options.

COMMISSIONER DUNN: Half of them exercised their options?

MR. HECHT: (Nodding head.)

COMMISSIONER DUNN: And taking delivery in London?

MR. HECHT: No. What they had done was, they had exercised them having Shearson sell the future into the market to close out the transaction.

COMMISSIONER DUNN: All right. All right. Okay.

MR. HECHT: That's the way they are doing it.

COMMISSIONER DUNN: But not by delivery of the physical --

MR. HECHT: No. These people don't want to a carload of potatoes in their front lawn. That's not the kind of person that's buying these options. Which once happened to me by the way about 11 years ago. I got a call from the railroad that said, "We have two carloads of potatoes, Mr. Hecht, where would you like them delivered".

COMMISSIONER DUNN: Well, if you could give us something on the volume, or the numbers of -- that are involved, it would be helpful.

MR. HECHT: Would you like it on a month -- I think they have records on the number of --

COMMISSIONER DUNN: Whatever is convenient, just to give some impression in the order of the magnitude.

MR. HECHT: Okay. I thought I made it clear before you can in that my client has agreed to register. We intend to file this week, as a CTA. I know in the past they have made their books and records available to your staff members in New York. And I'm sure that things can be worked out if they want to come in and look again, they are welcome to.

COMMISSIONER DUNN: Thank you.

CHAIRMAN RAINBOLT: Thank you very much for your presentation, it was very helpful.

Is there anyone who has not yet testified, who desires to be heard?

(No response.)

CHAIRMAN RAINBOLT: If not, on behalf of those of us at the Commission, and particularly myself, thank you very much for coming and spending a pleasant morning with us, and part of the afternoon. We appreciate your helping to try to make the regulations better. And perhaps develop an understanding of what is a very complex industry. This hearing is adjourned.

(Whereupon, at 3:15 p.m., the proceedings were adjourned.)

## CERTIFICATE OF REPORTER

I hereby certify, as the official reporter, that the foregoing proceedings were reported verbatim by me and thereafter reduced to typewriting by me or under my direction, and that this transcript is a true and accurate record to the best of my ability.

Luther P. Niehoff, CVR

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## COMPLAINT

IN THE
UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

NATIONAL ASSOCIATION OF COMMODITY
OPTION DEALERS, a non-profit
association
1666 K Street, N.W.
Washington, D. C. 20006

Civil Action No. 76- 2250

Judge A. Robinson

BRISTOL OPTIONS INC.
101 Maiden Lane
New York, New York 10038

CHARTERED SYSTEMS CORPORATION
5 Hanover Square
New York, New York 10005

BRITISH AMERICAN COMMODITY OPTIONS
CORPORATION
80 Wall Street
New York, New York 10005

CLEARY TRADING COMPANY, INC.
84 State Street
Boston, Massachusetts 02109

FIRST NEW YORK COMMODITY OPTIONS, LTD.
333 Sylvan Avenue
Englewood Cliffs, New Jersey 07635

FIRST WESTERN COMMODITY OPTIONS, INC.
OF LOS ANGELES
1801 Century Park East, Suite 2212
Los Angeles, California 90067

WILLISTON CORPORATION
199 Jericho Turnpike
Floral Park, New York 11001

LLOYD, CARR AND COMPANY
84 State Street
Boston, Massachusetts

INTERNATIONAL COMMODITY OPTIONS, LTD.
80 Pine Street
New York, New York 10005

vs.

THE COMMODITY FUTURES
TRADING COMMISSION
2033 K Street, N.W.
Washington, D. C. 20581

and

WILLIAM T. BAGLEY, Chairman
COMMODITY FUTURES TRADING
COMMISSION
2033 K Street, N.W.
Washington, D. C.

and

LAW OFFICES
GOLDSTEIN, AHALT
& BENNETT
CHARTERED
SUITE 300
HARTWICK BLDG.
4321 HARTWICK ROAD
COLLEGE PARK, MD. 20740

AREA CODE (301)
864-1109

JOHN B. RAINBOLT, II
Vice Chairman
COMMODITY FUTURES TRADING
COMMISSION
2033 K Street, N.W.
Washington, D. C. 20581

and

GARY SEEVERS, Commissioner
Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D. C. 20581

and

READ P. DUNN, Jr., Commissioner
Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D. C. 20581

and

ROBERT L. MARTIN, Commissioner
Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D. C. 20581

## COMPLAINT FOR DECLARATORY JUDGMENT AND INJUNCTIVE RELIEF

Plaintiffs, by and through their attorneys, bring this action against the Defendants, and complain as follows:

## JURISDICTION

1. This is an action for declaratory judgment under the provisions of 28 U.S.C., Sections 2201 and 2202, to declare null and void the proposed amendments to the various rules of the Commodity Futures Trading Commission dealing with commodity options, issued November 24, 1976 (Federal Register, Vol. 41, No. 228, pp. 51814, et. seq.), and proposed to be made effective in part on December 9, 1976, and in full on December 27, 1976, by the Defendants, and for a temporary restraining order, preliminary injunction and permanent injunction restraining the implementation, operation, and execution of said amendments to the rules.

2. This action arises under the provisions of the Commodity Futures Trading Act of 1974 [7 U.S.C. §§2, 6c(a), 6c(b), and 12(a) (Supp. V, 1975)], the Administrative Procedure Act (5 U.S.C. §§551 and 553) and Amendments IV and V to the United States Constitution.

3. Jurisdiction is vested in this Court by 28 U.S.C. §§1346(a)(2), 2201 and 2202, and the Administrative Procedure Act, 5 U.S.C. §§551 and 553. Venue is established under the provisions of 28 U.S.C. §1391(e). An actual controversy exists between the parties unto this action.

## THE PARTIES

4. The Plaintiff, National Association of Commodity Option Dealers ("NASCOD") is a non-profit Association, with offices at 1666 K Street, N.W., Washington, D. C. 20006. It represents approximately 17 American commodity options dealers, which is about half of all commodity option dealers in the United States and hundreds of the representatives of those dealers. One of the purposes of NASCOD is to represent its members when they are threatened by a violation of the principle of competitive equality or when they are threatened by unfair or illegal governmental regulation, and NASCOD is here suing in a representative capacity for all of its members who will be injured irreparably by the illegal acts here complained of.

5. Plaintiff, Bristol Options, Inc., is a commodity option dealer doing business in the State of New York. It is located at 101 Maiden Lane, New York, New York 10038.

6. Plaintiff, Chartered Systems Corporation, is a commodity option dealer doing business in the State of New York. It is located at 5 Hanover Square, New York, New York 10005.

7. Plaintiff, British American Commodity Options Corporation, is a commodity option dealer doing business in the State of New York. It is located at 80 Wall Street, New York, New York 10005.

8. Plaintiff, Cleary Trading Company, Inc., is a commodity option dealer doing business in the state of Massachusetts. It is located at 84 State Street, Boston, Massachusetts 02109.

9. Plaintiff, First New York Commodity Options, Ltd., is a commodity option dealer doing business in the State of New Jersey. It is located at 333 Sylvan Avenue, Englewood Cliffs, New Jersey 07635.

10. Plaintiff, First Western Commodity Options, Inc., of Los Angeles, is a commodity option dealer doing business in the State of California. It is located at 1801 Century Park East, Suite 2212, Los Angeles, California 90067.

11. Plaintiff, Willston Corporation, is a commodity option dealer doing business in the State of New York. It is located at 199 Jericho Turnpike, Floral Park, New York 11001.

12. Plaintiff, Lloyd, Carr and Company, is a commodity option dealer doing business in the State of Massachusetts. It is located at 84 State Street, Boston, Massachusetts.

13. Plaintiff, International Commodity Options, Ltd., is a commodity option dealer doing business in the State of New York. It is located at 80 Pine Street, New York, New York 10005.

14. Plaintiff, Yosh Nakazawa, is a customer of a commodity option dealer and has at least one (1) open option contract at the time of the filing of this action. His address is 906 Davis Street, Evanston, Illinois.

15. Plaintiff, Herbert T. Schneck, is a representative of one of the plaintiff option dealers, and is registered with the Defendant Agency as an "Associated Person." His address is 5410 15th Avenue, Brooklyn, New York.

16. The plaintiffs/commodity option dealers, described in paragraphs 5 through 15, are hereinafter referred to collectively as the "dealers".

17. Defendant, Commodity Futures Trading Commission, and Defendants Bagley, Rainbolt, Seevers, Dunn and Martin, are a regulatory agency of the United States and the Commissioners thereof, an agency created by the Commodity Futures Trading Commission Act of 1974, and said agency is charged by law with administrative and regulatory authority over commodity futures trading in the United States.

## IMMEDIATE AND IRREPARABLE INJURY

18. The Amended Rules are proposed to be made effective in part on December 9, 1976. Violation of these rules will subject the plaintiffs to civil penalties of up to $100,000. Furthermore, violation of the rules, if allowed to become effective, will subject the plaintiffs to a loss of their registration before the CFTC which will then prevent them from continuing in business; and will result in a loss of livelihood for them and the individuals employed by them, one of whom is the plaintiff SCHNECK herein.

19. Several of the plaintiffs are also registrants with the Securities and Exchange Commission and members of the National Association of Securities Dealers. A revocation of registration by the CFTC can be used as a basis for revocation or future denial of registration before the S.E.C. to the irreparable injury of the plaintiffs.

20. Finally, if the amended rules become effective and one or more of the plaintiffs cannot continue in business because of the restrictive and prohibitive nature of the rules, thousands of investors may lose the opportunity to exercise open option contracts to their irreparable injury. One of those investors is the plaintiff NAKAZAWA herein.

21. On the other hand, the defendants have not alleged in any public document or statement that there is any immediate or imminent danger to the public. The defendants have adequate enforcement tools and monitoring capabilities now and the granting of a temporary restraining order would work no injustice to the defendants.

## FIRST CLAIM

### The proposed rules are invalid as a matter of law in that they violate the express provisions of the Commodity Futures Trading Commission Act [7 U.S.C. §2(a)(1) and 19]

22. The allegations of fact hereinabove set forth are incorporated herein by reference.

23. The defendants, through the proposed amendments to Sections 1.3, 1.17 and Section 3.23 (Fed. Reg. pp. 51814 and 51815) are attempting to define the dealers as "Futures Commission Merchants", when in fact the Commodity Futures Trading Commission Act of 1974 defines "futures commission merchants" as meaning "individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract, market...." 7 U.S.C. §2(a)(1). Commodity option dealers do not, in fact, solicit or accept orders for the purchase or sale of any commodity for future delivery, but deal only in options. By attempting to define dealer as futures commission merchants, the defendants are obviously trying to cause the plaintiffs

to become subject to the requirements of Regulation 1.19, which prohibits a futures commision merchant from issuing or otherwise assuming financial responsibility for a commodity option transaction thereby ensnaring the plaintiffs in an intolerable "Catch 22" situation.

24. Since the defendants' proposed amendments are in conflict with the intent of Congress as enunciated in the Act, such amendments cannot stand.

## SECOND CLAIM

### The proposed amendments are an arbitrary and capricious action by the defendants, are an abuse of discretion and are not in accordance with the law, and are in excess of statutory right.

25. The allegations of fact hereinabove set forth are incorporated herein by reference.

26. The proposed amendments to Rule 1.17 establish a working capital requirement of Fifty Thousand Dollars ($50,000.0C for Future Commission Merchants ("F.C.M.s") who deal in options, but only a Ten Thousand Dollar ($10,000.00) working capital requirement for F.C.M.s that deal only in futures contracts. This is a totally arbitrary and capricious distinction and an unreasonable classification.

27. F.C.M.s dealing in futures contracts allow such transactions to be made on a margin basis taking only a small amount or deposit from the client on the full amount of the futures contract.

28. Options dealers do not execute options transactions until such time as payment in full has been received from customers, and therefore they do not have as great a need for working capital as F.C.M.s dealing only in futures.

29. Proposed Rule 32.4 providing for exemptions is totally arbitrary allowing the defendants to make completely subjective and capricious decisions, without guidelines, as to anyone whom they wish to exempt under the provisions of these regulations.

30. The proposed Rule 32.5 relating to disclosure is an unprecedented requirement by a regulatory agency to require an American businessman to advise his customers of his cost of goods sold and the profit that he is making. This is totally capricious and an excess of the defendants' statutory authority.

31. Rule 32.6 relating to segregation requires that the plaintiffs segregate ninety percent (90%) of every dollar which they receive in income from a customer in a special depository account within the United States.

32. The plaintiffs sell London commodity options. The London exchange, as the defendants well know, requires segregation of payments received from the plaintiffs, in London.

33. In the original "proposed interim rules" as promulgated by the defendants in the Federal Register of October 8, 1976, one hundred percent (100%) of all income received from a customer was to be segregated by the plaintiffs. The defendants have now arbitrarily and capriciously amended that to be ninety percent (90%).

34. Even as amended, the segregation which the defendants claim is for the purpose of protecting American investors from the insolvency of the plaintiffs and other F.C.M.s is totally inappropriate and unsatisfactory for that purpose.

35. In the event of the insolvency of the plaintiffs or any other option dealer, the American investor would have absolutely no claim to any of the monies segregated as they would be totally the property of the trustee in bankruptcy for the benefit of all unsecured creditors of the bankrupt and therefore no purpose is being accomplished by the segregation requirement which is therefore arbitrary and in excess of the defendants' statutory authority.

36. Regulation 32.7 dealing with record keeping requires that plaintiffs and other options dealers must keep the name of every person solicited even if the sale is not consumated, so that even if a potential customer is called, but no business transaction was ever concluded, information relating to that potential customer must be maintained for examination by the Agency.

## THIRD CLAIM

### The Interim Rules are contrary to the provisions of the Fourth Amendment of the United States Constitution and are violative of public policy

37. The allegations of fact hereinabove set forth are incorporated herein by reference.

38. The required disclosure regulations requiring that dealers disclose their mark-ups, fees, costs, and profits is an invasion of the right of the Plaintiffs to privacy, as guaranteed by the Fourth Amendment of the United States Constitution.

39. If the regulations promulgated are allowed to go into effect and remain in effect, they shall be contrary to public policy and contrary to the best interests of the public.

## FOURTH CLAIM

### The proposed rules violate the due process requirements of the Fifth Amendment to the United States Constitution

40. The allegations of fact hereinabove set forth are incorporated herein by reference.

41. The due process clause of the Fifth Amendment of the United States Constitution prohibits the deprivation of life, liberty, or property without due process of law.

42. Defendants herein are attempting, through the actions complained of herein, to deprive the plaintiffs of their property without due process of law.

## FIFTH CLAIM

### The proposed rules are contrary to the provisions of the Administrative Procedure Act in that the defendants action is without observance of procedure required by law

43. The allegations of fact hereinabove set forth are incorporated herein by reference.

44. Section 553 of the Administrative Procedure Act requires that rules or regulations which are proposed by an Agency must be published and cannot thereafter be effective for a period of thirty (30) days.

45. The "proposed interim regulations" promulgated by the defendants in the Federal Register of October 8, 1976, never gave notice to the plaintiffs or other members of the public that these were the rules and regulations of the Agency, but were rather entitled "proposed interim regulations" and since those were only the regulations which were then being proposed, there was no adequate notice for a period of thirty (30) days that the final regulations that the Agency had decided on were to be.

46. Wherefore, the plaintiffs pray for a declaratory judgment that the aforesaid proposed rules are null and void and for a temporary restraining order, preliminary and permanent injunction prohibiting the defendants from enforcing said rules.

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IN THE
UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

NATIONAL ASSOCIATION OF COMMODITY
OPTION DEALERS, ET AL.

Civil Action
No.__________________

vs.

THE COMMODITY FUTURES TRADING
COMMISSION

## MEMORANDUM IN SUPPORT OF COMPLAINT FOR DECLARATORY JUDGMENT AND INJUNCTIVE RELIEF

## STATEMENT OF FACTS

The trading of commodity futures began in the United States in centralized markets in the late 1700's. Those markets were largely cash markets for "spot" delivery. Farmers discovered that at harvest time the supply of meat and grain far exceeded the immediate short term needs, but at other times of the year supplies of these commodities were unavailable. Inadequate storage and transportation difficulties added to the problem. For this reason active trading in agricultural futures developed in the late 1800's.

Futures trading projects demand and price into the future and provides a means of appraising supply and demand conditions and dealing with price risks over time and distance. Early futures trading was marked with unbridled speculation, recurrent market manipulations and spectacular price fluctuations.

The irresponsible trading and lack of effective market regulations led, in 1884, to the first bill to prohibit futures trading in the Congress, followed by a long succession of similar bills for the next fifty (50) years.

Around 1900 the trend moved away from abolition and toward regulation. In 1922 the Grain Futures Act was passed based on the Interstate Commerce Clause of the Constitution. This Act was designed to enable the Government to deal with exchanges themselves and not individual traders. The Government licensed contract markets and these markets, or exchanges, took the responsibility for prevention of price manipulation by their members.

After Congressional hearings in 1934-1936 the legislation was amended and renamed the Commodity Exchange Act. Additional authority was granted to deal with market abuses by traders as well as exchange members. In 1974 the Congress passed additional amendments to the Commodity Exchange Act renaming it the Commodity Futures Trading Commission Act of 1974. In that Act they established the Commodity Futures Trading Commission, taking the regulatory function from the Department of Agriculture and vesting it in the new regulatory agency. For further background on the trading of futures in the United States see Report on H.R. 13113, Report Number 93-1131, U.S. Government Printing Office, August 29, 1974, pp. 11-15.

Section 402 of the Commodity Futures Trading Commission Act of 1974 provides, in part, that no person shall enter into option-type agreements, if such agreements are contrary to any rule, regulation or order of the Commission prohibiting such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one (1) year after the effective date of the Acts. After several delays the Commission has enacted a regulatory scheme relating to option-type transactions.

The Commission takes the position that because they believe they have the authority to prohibit certain options transactions, they also had the authority to ban options trading completely and therefore any action taken by them short of banning the trading of options should be acceptable.

The Act contains specific prohibitions against options transactions in the regulated commodities enumerated in the Act. In about 1973, a number of American businessmen realized that the American law governing options was relevant only to those commodities which were regulated. Non-regulated commodities, such as those traded in London could be the subject of commodity options contracts.

The trading of both English and world futures contracts has been carried on in London for centuries. There are a number of market associations dealing in various commodities. Representatives of each of those associations make up the London Commodity Exchange Company and contracts are cleared through the International Commodities Clearinghouse and the London Metals Exchange. The Clearinghouse is a wholly owned subsidiary of United Dominions Trust Bank, which is an authorized bank and as such acts as an agent of the Treasury for Administration of the exchange control regulations.

The Bank of England does not approve or disapprove of any of the futures markets or any of the market operations, but they are essentially self-regulating. The Bank exercises general supervision over the markets within the United Kingdom.

It is generally believed that in the one hundred seventy-four (174) years that the trading of commodities has been institutionalized in London, there has never been a default, which has affected a customer.

Nearly all members of the I.C.C.H. are floor members or non-trading members of exchanges. The advantages of membership in the I.C.C.H. include a reduction of commissions and the opportunity to deal trhough more than one broker offsetting open positions against each other for margin purposes.

Trading in London is conducted when a seller and buyer agree on the transaction on the floor of a particular exchange or during off-floor trading. Floor trades are done by open outcry. Options on futures contracts on cocoa, coffee, dry combed wool, rubber and sugar are transacted under the regulation of the I.C.C.H.

The purchase of an option allows a customer to have the right to exercise his option during a fixed period of time and, upon exercise, to purchase the underlying futures contract or the physical commodities themselves at a fixed price. A profit is made if the price of the underlying commodity or contract moves in a sufficient amount to cover the cost of the option. When the buyer pays for the option the seller's (grantor's) funds are segregated and earn interest for the grantor. Upon exercise of the option or lapse of the option period the funds are then released to the grantor.

Futures contracts may be purchased on margin, that is, a percentage of the actual price of the contract, subject to later adjustment and final payment. Options transactions, on the other hand, are not sold on a margin basis in the United States, but are on a cash basis.

The I.C.C.H. guarantees the transactions to its members. Hence, if an I.C.C.H. member goes bankrupt the debts are settled to other members. If there is a bankruptcy, and none are on record to the knowledge of the plaintiffs, the I.C.C.H. takes the customers' accounts into its own account and will offset those or give the customers the choice of other member firms with which they would like to carry their accounts. The I.C.C.H. has a very close working relationship with the controlled committees of each individual exchange which can monitor the individual positions in the futures market and request liquidation or request reduction of positions if they see fit. A further explanation of London trading is contained in the Report of the Advisory Committee on Definition and Regulation of Market Instruments to the Commodity Futures Trading Commission, July 6, 1976, pp. 121-131).

Since 1973, American firms have been dealing in "London options". The options are purchased by the American firms either directly through a member of the I.C.C.H. or through a wholesale firm which purchases from a member of the I.C.C.H. Since "London Options" have been sold in this country many thousands of American investors have found this to be an attractive investment vehicle because they allow commodity trading with a pre-determined risk. A client can make sizeable gains with his risk being limited to the amount that he has paid for the option and other attendant charges. When dealing in futures a client can lose not only the margin deposit which he has placed, but also substantially greater sums when he must settle on the futures contract. It is for this reason that option investment has become so popular among investors.

The plaintiffs allege that if the proposed rules are allowed to go into effect many, or perhaps all options dealers will be forced to discontinue their business operations. This will leave thousands of American investors without the means for exercising their open contracts. The defendants will then be causing the exact loss they are attempting to prevent through their regulations.

In the history of American options trading there have been one or two rather large failures. About a year ago, J. S. Love & Associates Options Ltd. declared bankruptcy. Apparently, the anti-fraud provisions of the CFTC's regulations were never enforced and there was no monitoring of Love's activities by the Agency. Upon bankruptcy, a number of customers lost their investment due, in part, to the fact that many weeks passed until effective and adequate control of the situation was taken. During this time a number of options expired and the customers were not able to exercise their options.

While the CFTC has been considering options regulations for over a year and a half the Love situation seemed to propel the Agency into its attempt to regulate the business affairs of the plaintiffs and the American industry trading in "London options".

The "proposed interim rules" promulgated by the CFTC on October 8, 1976 was the culmination of several publications in the Federal Register.

On October 22, 1975, the Commodity Futures Trading Commission announced that it was considering the adoption of rules to regulate transactions in commodity options, including the promulgation of temporary rules pending the adoption of a definitive regulatory program. See 40 F.R. 49360 (October 22, 1975). On February 20, 1976, the CFTC proposed comprehensive regulations governing off-exchange commodity options transactions, including so-called "dealer options". In its release on the proposed regulations, the CFTC invited interested persons to submit comments and to participate in oral hearings which were held in Washington, D.C. on March 8, 1976. At that time, the Commission noted that it was considering delaying the adoption of comprehensive regulations until it had an opportunity to study the recommendations of its Advisory Committee on the Definition and Regulation of Market Instruments. Finally, on October 8, 1976, the CFTC announced that it was considering adopting regulations under the Commodity Exchange Act as amended ("Act"), 7 U.S.C., 1 et seq. relating to commodity options. See 41 F.R. 44560 (October 8, 1976). In the announcement the CFTC solicited comments on the "Proposed Interim Regulations" in order to determine whether they should be modified. Further, the announcement contained the proposed effective date for the interim regulations - November 22, 1976. The legal authority under which the Proposed Interim Rules were proposed is 7 U.S.C., Sections 2, 6(c)(a), 6(c)(b), 12(a).

The Commodity Futures Trading Commission announced in the Federal Register Vol. 41 at 44561 that "the proposed interim regulations have been primarily designed to provide adequate customer protections in the offer and sale of commodity options". In COMMODITIES Magazine, November, 1976, CFTC Commissioner John Rainbolt stated: "You have to squeeze the business dry. I'm concerned that the segregation thing is going to be hard for some people in the business. But I know its going to be a lot harder for the little guy than it is the big guys...when all this goes into effect, we get the business cleaned up and traders are registered then we can begin talking about something."

Under the chairmanship of Vice Chairman of the Commission John Rainbolt II, an Advisory Committee on the Definition and Regulation of Market Instruments was appointed. The Commission has alleged that that group met thirty-three (33) times, and on July 15, 1976, the Advisory Committee issued its report, which was reported in the Commerce Clearing Housing COMMODITY FUTURES LAW REPORTS, Extra Edition, No. 26, of July 15, 1976. That Advisory Committee, and most particularly the Subcommittee on Commodity Options of the full Committee, had among its members not one London options dealer. In public statements, Commissioner Rainbolt has said that the Advisory Committee had two highly experienced members, Sam Israel, Jr. and Dr. Henry G. Jarecki. The Commission itself has described Mr. Israel as "a coffee importer with the green coffee firm of ACLI International, Inc., New Orleans, and a former President of the Board of Commissioners of the Port of New Orleans". Page 178, Exhibit VII, Biographies of the Members of the Advisory Committee on Market Instruments, Report of the Advisory Committee on Definition and Regulation of Market Instruments, July 6, 1976. Henry G. Jarecki is described as "Chairman of the Board of Mocatta Metals Corporation, New York; Director of Mocatta and Goldsmid, Ltd., dealers in bullion in London since 1684; and an Assistant Clinical Professor of Psychiatry of the Yale University School of Medicine". He is also described as holding membership in the Chicago Board of Trade and other commodity exchanges. Exhibit VII, at pp. 178 and 179. The Chairman of the Advisory Committee, Vice Chairman of the Commission John V. Rainbolt, II, is described in the same biographical material as being a native of Oklahoma, a graduate of its University and Law School, a lieutenant in the United States Army, Legislative and Administrative Assistant to a Congressman, and an Associate Counsel and Counsel to a Committee of the U. S. House of Representatives. Other members of the Committee include two lawyers in the private practice of law in the City of New York; a Vice President and Purchasing Director of the Coca-Cola Company; the Director of the Commodities Division of Merrill Lynch, Pearce, Fenner and Smith, Inc. (it is not known whether Merrill Lynch is engaged in the business of selling London commodity options. That company is not a member of NASCOD and the Plaintiffs herein do not believe that it is involved at all, and certainly not actively, in the sale of London commodity options); and a professor and economist with the Food Research Institute at Stanford University and past consultant to the National Grain and Feed Dealers Association, U. S. Department of Justice, Cotton, Incorporated, Securities and Exchange Commission, Department of Agriculture, and "the White House". In his unpublished remarks, Vice Chairman Rainbolt referred only to Dr. Jerecki and Mr. Israel as the individuals supposedly having the expertise in London commodity options. Unpublished remarks of John V. Rainbolt II, Futures Industry Association luncheon, Union League Club, Chicago, Illinois, November 12, 1976.

The Commission does not have any experience or expertise within its staff on the question of London commodity options. Its entire expertise is vested in its advisory committee and the Commission makes heavy use of its advisory committee system. The proposed rules as promulgated by the Commission are contrary, in nearly every respect, to the report of its own advisory committee. While members of the advisory committee obviously have vast experience in the general area of commodities, no member of that committee has any experience in the specific area of London commodity options.

Furthermore, the Commission proposes to establish a domestic options exchange so that all trading in the future will be on that exchange. The regulations pertaining to domestic options exchanges are the Part B Regulations referred to in the Federal Register of October 8, 1976 and it is anticipated by the Commission that those regulations will become effective before March 1977.

The Commission has promulgated these interim regulations allegedly because they protect consumers between now and March in the apparent feeling that there is some great need for regulation during this brief period. The Commission claims that there are abuses within the industry and to that end it has brought three (3) enforcement proceedings against Commodity Option Dealers. Two (2) of those actions resulted in consent orders being entered into without an admission or denial of the alleged actions by the defendants and the third resulted in a refusal by the United States District Court for the Southern District of New York to grant an injunction as requested by the Commission. In short, there has not been any proof or judicial finding of fact that abuses do exist in the industry.

The Commission has undertaken a studied course of systematic prejudice against the small independent businessmen

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who are members of NASCOD and of this infant industry as evidenced by Commissioner Rainbolt's comments in Commodities Magazine (Exhibit I). The actions brought by the Agency so far have been against the two (2) largest volume option dealers in the United States and another large option dealer. And yet Commissioner Rainbolt and the Commission are promulgating regulations which Rainbolt acknowledges will be particularly detrimental to smaller firms.

In response to the Federal Register Notice of October 8, 1976 requesting comment on the "proposed interim rules" the plaintiffs submitted a comment letter, a copy of which is attached hereto as Exhibit "II". As a result of that comment letter and others the Commission met on November 18, 1976 to consider the comment letters. On November 24, 1976, the Commission issued "General Regulations Under the Commodity Exchange Act, Acoption of Rules." F.R., Vol. 41, no. 228, November 24, 1976, pp. 51808 et. seq.

The plaintiffs now come before this Honorable Court speaking pre-enforcement review of the rules adopted by the Commodity Futures Trading Commission.

## ARGUMENT

### FIRST CLAIM

The proposed rules are invalid as a matter of law
in that they violate the express provisions of the Commodity
Futures Trading Act [7 U.S.C., Section 2(a)(1) and 19].

An option is defined as a privilege existing in one person, for which he has paid money, which gives him the right to buy certain merchandise or certain specified securities or commodities or commodity futures contracts from another person, if he chooses, at any time within an agreed period, at a fixed price, or to sell such property to such other person at an agreed price and time. If the option gives the choice of buying or not buying, it is denominated a "call". If it gives the choice of selling or not, it is called a "put".

If it is a combination of both these, and gives the privilege of either buying or selling or not, it is called a "straddle" or a "spread eagle".

There is no obligation on a party entering into an option contract to make any payment, except such as may be agreed on between the parties as consideration to support the option, unless or until he makes up his mind within the time specified to make the purchase or sale which he has the right to do. The sale of an option is not a sale of the underlying commodity or commoditiy futures contract.

Proposed amendments to rules 1.17 and 1.3 and proposed section 3.23 attempt to define options dealers as "futures commission merchants" when in fact, the Act itself limits futures commission merchants to those dealing in the purchase or sale of any commodity for future delivery.

By defining the plaintiffs as F.C.M.s the defendants are attempting to prohibit them from dealing in options pursuant to Regulation 1.19 which prohibits F.C.M.s from selling options in which they have a financial interest. This is the manner in which business is done in the United States at this time and the defendants appear to be opposed to allowing options dealers to have a financial obligation to the clients for the fulfillment of the option upon exercise by the option customer.

## SECOND CLAIM

### The Proposed Amendments Are An Arbitrary And Capricious Action By The Defendants, Are An Abuse Of Discretion And Are Not In Accordance With The Law, And Are An Excess Of Statutory Right."

General notice of proposed rule making is required to be published in the Federal Register. This requirement is found in the Administrative Procedure Act, 5 U.S.C., 551 et seq. The Administrative Procedure Act in Section 553 explains the required procedure for agencies in formal rule making. The enabling statute of the CFTC triggers the need for the application of language in this statute. The general notice in the Federal Register must contain (1) a statement of the time, place and nature of public rule making proceedings; (2) reference to the legal authority under which the rule is proposed; (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved [5 U.S.C., Section 553]. "After consideration of the relevant matter presented, the Agency shall incorporate in the rules adopted the concise general statement of their basis and purpose. 5 U.S.C., Section 553(c).

The enabling statute of the CFTC and the administrative Procedure Act grant the rule maker, in this instance the Commodity Futures Trading Commission, a broad rule making power. With the broad power goes a broad responsibility. The rule maker must be presented with all relevant evidentiary factors. He must give serious consideration to those factors and he must use reason rather than whim to proceed from initial assumptions to final conclusions.

The basis of all government is fundamental fairness to the public. When a rule maker hides his reasons for crucial decisions or when he fails to give good faith attention to all the information and contending views solicited and relevant to the issues before him unfair treatment is given to that public. In Wingo v. Wedding, 418 U.S. 461 (1974), the Supreme Court held that because an agency is expert in finding facts does not mean that its fact-finding must be conclusive. If it were conclusive the right of review guaranteed by the Administrative Procedure Act, 5 U.S.C., Section 702, would be meaningless.

The scope of the review granted by the Administrative Procedure Act is found in Section 706:

"To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall - (2) hold unlawful and set aside agency action, findings, and conclusions found to be - (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; in making the foregoing determinations, the court shall review the whole record of those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error."

Arbitrariness normally means that there is no reasonable ground for a decision. In Mourning v. Family Publications Service, 411 U.S. 356 (1973) the Supreme Court of the United States held that a reviewing court has the power to decide if a regulation is "reasonable". The Court must find that an agency reasonably believed that no feasible alternatives exist or that existing alternatives create and involve unique problems. Overton Park v. Volpe, 401 U.S. 402, 4016 (1971). Two grounds are given for upsetting informal rules promulgated pursuant to Section 553 of the Administrative Procedure Act. The first is whether the basis and purpose statements required by the statute is published in the Federal Register and whether in that statement includes no reasons or merely conclusory reasons. In either case the failure of good faith consideration of relevant matter would be indicated. The second ground is reliance on findings or assumption not made public, prior to the promulgation of these particular rules.

The proposed amendments to Section 1.17 require that F.C.M.s engaging in commodity options transactions should have a working capital requirement five times that of other F.C.M.s. The Defendants justify this arbitrary distinction "based on its experience," (F.R. November 24, 1976, p. 51813) but do not state what that experience is, other than to allude to the fact that there are problems within the industry. The Federal Register Notice goes on to say that the additional working capital "is necessary to provide a cushion against losses which are more likely to arise in the commodity options area." There is no indication that losses are more likely to occur. The defendants have absolutely no idea as to the number of options being sold in this country today, nor do they know who is selling options, nor do they have a clear understanding as to the method in which business is being done.

Under its regulations, the Agency, heretofore, has not required the registration of options dealers, except in a category known as "Commodity Trading Advisors", which category contains many other types of individuals and businessmen. The defendants' bald allegation that losses are more likely to occur is totally without basis in fact. In fact, losses occur in the futures industry every single day, enforcement actions are taken against futures commission merchants continually and futures commission merchants deal on a "margin" basis and the customers are much more likely to lose large sums of money than in the cash transactions, such as an option sale.

Proposed Rule 32.6 relating to segregation requires that plaintiffs segregate ninety percent (90%) of every dollar which they receive in income.

On page 51812 of the Federal Register of November 24, 1976, the defendants state as the purpose for their double segregation requirement that, "The Commission stressed that what is of paramount importance is that option customers be assured, at the very least, that the assets which they put up to purchase a commodity option will be safe during the term of the option, and be available to be refunded in the event that an option customer exercises the option but is unable to obtain satisfaction of the obligation owing to him because of the insolvency of his futures commission merchant or its principals."

The defendants intended purpose then is to provide, in the event of bankruptcy or insolvency, for a fund which the customers may go against, theoretically as preferred creditors. In fact, such a fund is totally inappropriate for the purpose intended and that under the Bankruptcy Act (11 U.S.C., §96), such a claim would not be recognized.

The funds, that were "segregated" would represent fees and commissions earned by the options dealer when the option was sold and the balance would also represent the options dealer's general working capital, since the customer's money would have been sent on to London for the purchase of the option. The actual funds in segregation would belong to the option dealer, not the customer. As such, the trustee in bankruptcy would immediately have title to all such segregated funds for the benefit of all general and secured creditors.

In the matter of J.S. Love & Associates Options, Ltd., Bankrupt, Bankruptcy no. 76B590, United States District Court for the Southern District of New York, the defendants filed an Amicus Curiae brief and on page 5 of which acknowledged that no cases had been found applying general trust principles to situations involving commodity options, or the profits therefrom. No such cases do, in fact, exist and the only relief that was afforded in the aforesaid bankruptcy action was to allow customers, who could trace their options, to have possession of and exercise those options. The court there did not deal with the issue of whether funds being held in a "segregated account" would be a part of the bankrupt's general working capital.

In the Commission hearing of November 18, 1976, Defendant Bagley, Commission Chairman, asked his General Counsel, how he had determined to use a ninety percent (90%) segregation figure. The reply was that there was no factual basis. There is no official transcript of those proceedings but the plaintiffs have made a transcription and attach copies of pages 21-23 hereto as Exhibit III.

The plaintiffs in a recent "Position Paper" attached hereto as Exhibit IV, have shown that the defendants estimate of ten percent (10%) for overhead is totally out of line with reality and that the estimate of the defendants is arbitrary.

## THIRD CLAIM

"The Fourth Amendment of the United States Constitution Guarantees To The Plaintiffs Their Right to Privacy."

No businessman in America is required to reveal to his customers the amount of his profits or other costs. Industry in the United States was developed on the theory of capitalism, wherein the market place is allowed to determine the price of goods.

The defendants seem to believe that the plaintiffs are the agents of their customers, but this is no more true than it is with the car dealer who takes orders for cars or the insurance man who sells insurance to his customers.

The plaintiffs have the right to the privacy of their business affairs, which the defendants are attempting to deprive them of.

## FOURTH CLAIM

"Due Process of Law Is Established By
The Administrative Procedure Act, Heretofore Cited."

The defendants are attempting through the actions complained of to deprive the plaintiffs of their property without due process of law.

## FIFTH CLAIM

On October 8, 1976, the defendants published "proposed interim regulations". What should have been published were "interim regulations". Anyone reading the Federal Register would simply be led to believe that the Agency was publishing regulations for comment, pursuant to the Administrative Procedure Act, but not necessarily for enactment.

The defendants have confused the provisions of the APA dealing with proposed rule making with the promulgation of proposed rules.

GOLDSTEIN, AHALT & BENNETT,
CHARTERED

By: ______________________
Leonard R. Goldstein
Attorney for Plaintiffs

EXHIBIT I TO MEMORANDUM

EXHIBIT I

COMMODITIES November 1976

# Rainbolt: *We have to get the crooks out first*

Is trading in London commodity options about to be wiped out by new CFTC regulations coming into effect? For some, it very well could be and for very good reason, CFTC officials contend.

Commodity options have become a very hot item in the U.S. recently, leading to some reports of abuses and ripoffs by some firms who charge high premiums and provide little protection for the customers' funds.

As the CFTC moved toward regulatory controls which will eventually lead to trading in domestic commodity options, there were two areas of confusion in proposed CFTC regulations on commodity options.

One involves the status of the Futures Commission Merchant (FCM) and whether he's eligible to handle commodity options. One provision apparently says all options dealers must register as FCMs: but another section says FCMs are prohibited from handling options. CFTC officials say that interpretation is a misreading of the regulations and is not in line with policies outlined several years ago.

"This is not a problem as far as we're concerned at this time," CFTC Commissioner John Rainbolt told COMMODITIES in mid-October. Previous opinions by Alex Caldwell, head of the old CEA before its duties were taken over by CFTC, indicate that the regulations do *not* prohibit anybody from being a broker for London options. CFTC's gone along with that thinking since and sees no trouble allowing the FCM to sell options although requirements for becoming a registered FCM might eliminate some potential traders.

## Segregated Funds Big Question

The other confusing area is segregation of customer funds and keeping them in the U.S. That *does* pose a problem for the near-term future of London commodity options trading in the U.S.

"We're looking carefully at the new rules to see whether we can comply," an official at one of the top options firms in the U.S. told COMMODITIES, "but I would bet that not more than five firms in the whole country can survive the new regulations in their current firm. It's like using a pile driver when a hammer would have been enough."

If the rule does go into effect as at first proposed, it would mean that options firms would have to have two accounts to trade options, one in London to acquire the option and the other in the U.S. to serve as a customer protection fund. Few options firms have that kind of extra money available to put up double premiums, and few would be willing or able to go to the bank to get such financing. London officials were to meet with CFTC officials in late October to consider some ideas on how funds might be segregated in London rather than in the U.S., but Rainbolt was not convinced that any alternatives presented ahead of that meeting were acceptable.

## Squeeze on Crooks

The proposed segregated fund rule would really put the squeeze on the smaller options firms. That would suit Rainbolt.

"We have got to clean up the options business in this country first — you have to get the crooks, the bunko artists, the hot check artists out," he emphasizes. "You have to squeeze the business dry. I'm concerned that the segregation thing is going to be hard for some people in the business. But I know it's going to be a lot harder for the little guy than it is the big guys. And I know the little guys in this business are generally the ones ripping off the public — I know some big ones are doing it, too. The real problems are the fly-by-night operators, and you've got to get them out. At the same time, if you're going to leave them in, you have to provide some basic rudimentary customer protection which we don't have now. And a basic tenet of the commodities industry has always been the segregated fund.

"When all this goes into effect, we get the business cleaned up and traders are all registered, then we can begin talking about something," says Rainbolt.

At that point, it would be time to consider domestic commodity options trading on contract markets. Early 1977? It's too early to say, according to Rainbolt, who points out that a number of details still have to be studied more thoroughly to see if options are a viable and desirable trading tool. ■

EXHIBIT II

EXHIBIT II TO MEMORANDUM

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November 8, 1976

Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Attn: Secretariat

Gentlemen:

I represent the National Association of Commodity Option Dealers (NASCOD). On their behalf I am writing to comment on the interim rules pertaining to commodity options as they appeared in the Federal Register of Friday, October 8, 1976.

The National Association of Commodity Option Dealers is a nation-wide association representing firms which are engaged in the business of dealing in commodity options. Our membership is drawn from the more than one thousand individuals engaged in this business. Our members serve over 20,000 investors in an industry which NASCOD estimates at approximately five hundred million dollars worth of commodities per year.

Before commenting on the specific proposed rules, I bring to your attention three (3) major concerns of the Association:

1. Necessity of Interim Regulations

The Association does not believe that your regulations are warranted in light of the proposed establishment of an American options exchange.

The regulations which you have proposed are excessively stringent to accomplish the purposes seemingly enunciated in the Federal Register. There is widespread feeling within the industry that the Agency is attempting to annihilate option dealers by promulgating regulations which are inconsistent with the ability of any dealer to continue in business. You have proposed the establishment of a domestic options exchange in a few short months and we simply cannot understand why short-term regulations, obviously designed only to have effect until the domestic market is established, are so imperative. We know of no member of the Agency staff who has ever been a part of a firm which deals in options and therefore it is difficult for us to understand from what source, if any, you have obtained the factual basis for your proposed regulations. No public hearing has ever been held on the regulations, and I understand that you do not now propose to have any such hearing. It is obvious that your regulations will have substantial, if not devastating, economic impact on the option industry, and that substantial rights and privileges will be lost by the members of our Association and the entire option industry. We therefore suggest that the Agency devote its best efforts to hastening the effective date of the establishment of domestic markets and allow those markets to regulate their own members under the Agency's supervision.

## 2. The Absence of Any Public Hearing.

The National Association of Commodity Option Dealers (NASCOD) requests that the Commodity Futures Trading Commission (the Agency) hold a formal evidentiary hearing concerning its proposal to amend Chapter I of Title 17 of the Code of Federal Regulations, effective November 22, 1976, by amending Section 30.01 and by adding a new Part 32 under the Commodity Exchange Act. We further request that NASCOD be given an opportunity to call and cross-examine witnesses and introduce documentary and other evidence at that hearing.

This request is made in view of the unique and severely adverse impact that the Agency's proposal will have on the commodity options industry. Due to the impact of this proposal the only appropriate procedure in this case is a hearing in which NASCOD and others have an opportunity to introduce and cross-examine witnesses.

Although the Agency's release cites several sections of the Act as its authority to adopt these proposed changes, we believe the Act does not confer the broad power to permit the action contemplated by the Agency. To the extent the Act is silent or inadequate to compel a particular change, there is no basis for inferring a broader independent power under the Act. Since the Act does not confer power on the Agency to adopt all the changes contained in the release, we believe the Agency is not authorized to act. As you know, while the Agency has broad powers to regulate the option industry, such orders, rules and regulations may only be prescribed after an opportunity for hearing. Since Congress did not use the words "opportunity for comment", we can only assume that a hearing must be scheduled.

To date, neither NASCOD nor any other party in interest has been accorded any hearing on the specific proposals contained in the Federal Register. An earlier hearing dealt only with very broad concepts - not the specific proposals now being promulgated.

As you know, there are hundreds of registered Commodity Trading Advisors, many of whom engage in the sale of commodity options. Many of these firms will be forced to terminate their business activities leaving what the Association believes to be more than a thousand individuals without a means of livelihood and thousands of American investors with open options contracts.

Considerations of fundamental fairness and due process also require that NASCOD have a hearing of the type requested in order to protect its members' interests adequately. We are prepared to submit a lengthy legal memorandum analyzing the relevant authorities, as well as substantial economic justification for the continuation of options trading.

The Agency has stated its views only in general and conclusory terms. In the absence of a hearing, there will be nothing to reveal findings on the numerous specific factual issues presented, and how these findings support a view that the Agency's proposals are necessary to protect the public interest and promote just and equitable principles of trading. As a necessary corollary of the right to judicial review, the Commission must hold a hearing in order to create a record supporting the facts on which the Agency bases its judgment. We believe that the ultimate value judgments as well as the underlying factual assumptions of many witnesses would be subject to considerable re-evaluation if they were exposed to cross-examination.

It seems clear that certain groups have an economic interest in opposing the competition resulting from the present form of options trading. Despite the hearing which the Agency held, no witness has had to defend his views under cross-examination by an adverse party.

We believe that several matters have not been considered adequately, or at all, by the Agency. Subjects on which a hearing would focus should include the following:

1. The nature of futures option trading in the United States and on the London markets. The proposed rules do not indicate a precise understanding of the existing methods of conducting business in this country or on the London markets. While it is true that your staff has been to London on several occasions, the record is devoid of any testimony by representatives of the London markets on their methods of doing business. I know of no American firms who have met with your staff to discuss industry practices.

2. The Commission has not defined their principal regulatory concerns. As a result, the proposed rules totally impair our members' ability to engage in legitimate business transactions without demonstrating who is being protected or benefitted. The principal concern of the Agency should be the protection of customers' funds and the proper marketing of options in the United States. This letter contains the outline of a plan which describes in detail how the Agency can accomplish these objectives without a total prohibition of options trading.

3. What are the anti-competitive effects of the Agency's proposal? Is the Agency's proposal necessary to make the Act work after considering its effect upon competition and the public policy favoring competition? If so, is it the minimum restraint on free competition which could achieve the purposes of the Act? Unless such questions are answered in the affirmative, after a factual examination of the anti-competitive factors involved, the proposed regulation will create an unwarranted conflict with the anti-trust laws.

The Agency must acknowledge its obligation under the Act to consider the public policy favoring free competition. Section 15 requires that the Commission shall take into consideration the public interest to be protected by the anti-trust laws and endeavor to take the least anti-competitive means in adopting any Commission Rule. However, the Agency has not in any of its pronouncements on options trading explored adequately the anti-competitive implications and effect of its proposed rules, including particularly, the disastrous impact which such rules will have on our member firms as a competing force in the marketplace. Less restrictive alternatives are available to accomplish the Commission's apparent objectives (assuming arguendo the validity of those objectives). Several specific aspects of the anti-competitive effect of the proposed exclusionary rule require examination and a hearing.

A. Why should all options trading occur on boards of trade designated by the Commission and on recognized foreign commodities exchange systems? If the purpose is to protect customers, the result might be accomplished by establishing rules to cover option trading which occurs off boards of trade. Witnesses should be able to present testimony and be examined on whether the limitation of options trading to boards of trade is necessary to assure the desired result. As in most anti-trust cases, such determination requires any conflicting data be subject to cross-examination. In this connection, we know of no evidence that the Agency has to rationalize its different treatment of options trading on and off boards of trade, except perhaps Agency oversight, which might be available in other ways. The extent to which regulatory problems are resolved by options trading only occurring on a designated exchange is a highly complex subject on which no adequate record has been developed.

B. To the unknowledgeable observer it might appear that the proposed regulations would, by virtue of the capital and segregation requirements, screen out under-capitalized firms and prevent investors from any lawsuits due to the financial collapse of a firm. As we have indicated above nothing could be further from the truth. Instead of excluding what might be considered marginal firms from doing business, the proposed regulations will prohibit all firms from doing any business. The larger the firm (and greater the sales) the more onerous the segregation requirements become.

Thus, the effect will be not to protect the public, but rather to prevent the public from engaging in a legitimate business of great value to the public and important to the national economy. Moreover, many existing investors will be left without the opportunity to exercise their open options contracts.

An evidentiary hearing should explore the level at which financial responsibility should be established and the requirements for segregation of customer funds. The Agency has not explained how the level for financial responsibility has been established and the impact of the segregation requirement.

### 3. The right of the Agency to Define Options Dealers as Futures Commission Merchants

Section 2(a)(1) of the Act defnies "futures commission merchant" as individuals, etc. engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery (emphasis supplied). Option dealers sell only option contracts which are rights to purchase. While it might be a fine distinction, I believe, nonetheless, that members of the Association do not solicit or accept orders for the purchase or sale of commodities for future delivery. For example, if a member of the Association sold an option to a customer and the writer of that option agreed to the validity of the option contract, but refused to deliver the commodity when the option was exercised, the seller of the option could not be held liable for the failure of the writer to perform. Even if the seller of the option were a guarantor of the option contract, he still could only be liable to the purchaser as a guarantor and not as a principal, so it cannot be said that the members of our Associaiton are soliciting or accepting orders for the purchase or sale of any commodity for future delivery.

As to the specific proposed interim regulations, NASCOD'S position is as follows:

The minimum financial requirements provided in Section 1.17 are both vague and arbitrarily discriminate against option dealers. The regulations provide that Fifty Thousand Dollars ($50,000.00) in adjusted working capital must be maintained, but nowhere is there a definition or formula for the computation of the Fifty Thousand Dollars ($50,000.00). If that figure can be arrived at by normal accounting standards you should say so. In various speeches and public presentations, members of your staff have variously described the means of determining adjusted working capital, and their explanations are not in accordance with standard accepted accounting procedures, but are considerably more difficult standards which would require an option dealer to have vast amounts of capital, far in excess of what a dealer would normally be expected to maintain to meet his obligations to his customers.

To require a futures commission merchant that deals in options to maintain Fifty Thousand Dollars ($50,000.00) in adjusted working capital, while any other futures commission merchant need maintain only Ten Thousand Dollars ($10,000.00) is arbitrary and discriminatory. In fact, an FCM who deals in margined futures accounts has a much higher financial risk, as well as a corresponding obligation to his customers. As I am sure you know, there are no margin accounts in options trading, so that if there is to be any differentiation within the category of FCMs it should be the exact reverse of the one you have proposed in Section 1.17.

Section 32.1(c) is ambiguous. What obligation does an option dealer have to a "customer" who indirectly acquires "any interest" in a commodity option. If a NASCOD member sells an option, he should not have the obligation of inquiring beyond the four corners of that transaction to determine whether any other individual, or other legal person, is acquiring any indirect interest. Rights of curtesy, dower, widow's share, secured creditors, may be involved and a whole host of assignees, trustees, and others may have some indirect interest in the option contract, but nowhere else in the law is any seller required to protect such long-removed indirect interests.

Section 32.3(2) puts the burden on the futures commission merchant to make a determination as to whether any individuals involved in his business has not registered, or that such registration has expired or been suspended or revoked. This provision puts an impossible burden on the futures commission merchant. To comply with the provisions of the rule, an FCM would have to virtually make a daily inquiry at the Agency as to the status of his employees. The provision should read that after notice by the agency to the FCM of the revocation, suspension or expiration of the registration of an employee the FCM may no longer have the individual associated with him. You are attempting to shift the burden of responsibility away from your Agency where it belongs. Furthermore, there is an inconsistency in this section where you have broadly referred to the status of "employee" when you have already provided in Section 32.3(b)(1) that individuals in clerical capacities (who are also employees) need not be registered.

Section 32.5, dealing with disclosure requirements, seems to demonstrate a total lack of understanding by the Agency of the mechanics of options dealing. While we accept and endorse the concept of commercially reasonable disclosure we know of no requirement in existing security or commodity regulations which requires twenty-four hours advance notice for each transaction. I am sure you must realize that furtures trading in general and, to a lesser though still significant extent, options dealing is very fast-paced. If twenty-four hours advance disclosure was required, many opportunities would not be able to be capitalized on by thousands of American investors. No legitimate analogy can be drawn to land sales and real estate settlement procedures which do require advance notice, because economic circumstances do not change as radically and on such a rapid basis in those situations. The Association believes that the Agency is required to accomplish its stated objectives with a minimum of regulation and while the Association does, as I have said, endorse the concept of knowledgeable purchases and reasonable disclosure, those consumer protection aspects must be balanced with the ability of knowledgeable investors to enter into commodity options transactions rapidly. Even the Agency's newly promulgated "risk disclosure" regulations are not nearly as stringent as the provisions of Section 32.5, which seems totally inconsistent with the fact that the opportunity for virtually limitless loss exists in futures, but does not in options.

The National Association of Commodity Options Dealers is prepared to work with your staff to develop an industry-wide brochure explaining to option customers and potential option customers the definition of terms, the computation of charges and price levels and the risks in options purchasing. This brochure would be available through the Association, through our members (all of whom subscribe to our high standards of practice), to the Agency if you wish to distribute it, and to non-member firms for their purchase and distribution. This would assure the Agency of uniformity within the industry so that hundreds of various disclosure statements would not have to be reviewed by your staff. Furthermore, such brochure would go further than your regulations require to educate and enlighten American investors on the effective use of commodity options as a part of an investment portfolio, and would explain the concepts of when and when not to use commodity options. This brochure would be far more beneficial and understandable to investors than a section 32.5 disclosure statement, which could be drafted by those seeking to avoid the requirements of the regulation, in such a way as to be totally confusing to potential investors.

Many aspects of the disclosure statement which the Rules require are unprecedented in American business. A consumer does not know, nor does he have the right to know what a merchant pays for goods he sells, what an insurance broker's compensation is from the insurance company or any other of the private information which a business firm does not and should not be required to disclose. For two hundred years this country has survived and prospered with the concept that the market place can and should determine the price and value of goods and services. Excessive governmental regulation of the type proposed in these Rules can do little to add to the force of the marketplace. Moreover, since the Agency proposes to have domestic markets for options, those markets can deal with establishment of prices and for the few short months until those markets are established, the proposed regulations dealing with disclosure are excessively stringent and unwarranted.

As to Section 32.6 being the regulations pertaining to segregation, the Association is not at all clear as to the Agency's purpose in proposing these rules. Surely the Agency must realize that no business firm in the world can segregate every dollar of its income for months or years and continue to hope to find the financial wherewithal to remain in business. If any firm were able to do this, it would only be through the use of extensive loans and lines of credit from lending institutions, the premiums for which would have to be passed on to the customer, thereby making investing in commodity options financially prohibitive.

To require the segregation of mark-ups, costs, fees and charges is indefensible. When a customer gives an option dealer money for an option and that option is subsequently acquired by the option dealer, his fee and other charges have then been earned. He has been paid to purchase an option for a customer and he has done so and at that point segregation of the fees and charges which he has earned should not be required.

To require the segregation of funds in a United States Bank is similarly without merit. Is the Agency suggesting that commercial banks in England, or other parts of the world, are inadequately managed or insufficiently funded such that they cannot be trusted as repositories for customers' funds? Is the Agency suggesting that the Bank of Engaland or other regulatory authorities throughout the world are incapable of controlling the practices of financial institutions under their authority? If this is so, then the Agency must defend its position in an evidentiary hearing to establish that English banks among others, cannot be trusted. If the Agency has some other reason to require U.S. segregation of funds, then that position must be announced, so that it can be dealt with. To reiterate my oft made comment, the Agency is charged with the responsibility of accomplishing its legitimate objectives with a minimum of regulation and we must know what the objective is in this instance so that we can have the opportunity to suggest viable alternatives. The Association suggests that if an English bank is prepared to provide an acknowledgement of its knowledge and agreement to comply with the requirements of Section 32.6(a), then that should suffice. As the Agency apparently does not know, the exigencies of doing business require that premiums belonging to option writers be maintained in English banks, where the writer can receive substantial interest income on his funds.

If it is the concern of the Agency to protect against the bankruptcy of an FCM this concern can easily be dealt with through segregation, in the United Kingdom, with adequate assurances being given, through an American bonding company, or otherwise, that in the event of a bankruptcy all American customers will be protected. In this way, the American customer is protected to a greater degree than under the proposed rules because in the event of a bankruptcy even secured creditors, such as options customers would have to make their claim and wait for the normal processing of a bankruptcy case. Customers wishing to exercise their options during this period would be required to appear before the Bankruptcy Court, perhaps thousands of miles from their homes, either personally or through counsel, to petition for a release of their funds from the segregated account so that the option-exercise transaction could be consumated.

The agency already has in its possession one or more documents from the London Commodity Exchange proposing that under their segregation rules when an American FCM goes bankrupt all funds being held by a London trader would continue to be held for the benefit of the customer so that options could be exercised, if so desired. Moreover, under the rules of the International Commodity Clearing House when there is a bankruptcy of a member of that clearing house, the accounts are instantaneously transferred to another clearing member so that there is no interruption in service to the customer. This method of doing business provides far greater protection to the American customer than that proposed by the Agency.

The regulations in Section 32.7 dealing with record keeping, are acceptable, in part, but again go to excessive lengths. Why should an option dealer be required to keep advertising material circulars, memoranda, publications, writings, and all other literature or written advice distributed to options customers or prospective option customers, except to assist your Enforcement Division in building a case against that option dealer. Your regulations presuppose the unlawfulness of the dealer. Since an option dealer is not required to advertise, publish or give advice then a regulation requiring that copies of these documents be retained is untenable. Moreover, to keep a list of every prospective customer solicited is ludicrous. There are perhaps hundreds of thousands of individuals being solicited, unsuccessfully, every year for the purpose of investing in many financial products, including commodity options. The burden of keeping such records is impossible and the Agency has stated no reason why it should be done.

The Association believes that it is critical that a working section be established so that the details of these plans can be brought to the attention of the Agency and taken into consideration by it in arriving at some reasonable modification in the promulgated regulations.

We believe that the most effective way to insure consumer protection while simulatneously allowing the many thousands of Americans involved in the investing in and marketing of commodity options would be through the cooperative effort between the regulatory authority and those being regulated.

The Association believes that this letter demonstrates that we have already planned and begun to effectuate programs and practices among our members which go further to insure consumer protection than even your proposed regulations. Our Code of Conduct, training programs, proposed disclosure brochure and consumer insurance proposal, among other programs, are more comprehensive than your regulations.

We strenously encourage and require that the proposed effective date of your regulations be extended beyond November 22, 1976, and that a public hearing be held giving members of the industry time to present, for the record, not only their position and comments on your regulations, but also to propose to your staff viable alternatives to the regulations. An extension of the effective date would also allow an opportunity for consideration of the proposal from the London Commodity Exchange. It is also our strong request that a workshop be established between the Agency, the LCE, the Bank of England and NASCOD, as well as others who might be interested, for the purpose of allowing your staff to receive additional information upon which to base further regulation.

I would appreciate your prompt attention and response in the hope that we can receive your commitment for an extension of the effective date, thereby avoiding the necessity of my taking any further action to protect the interests of the members of the National Association of Commodity Option Dealers.

Very truly yours,

Leonard R. Goldstein

Leonard R. Goldstein

LRG:pm

and discussed the question of double segregation and I think what the Commission discussed at that time was in effect that by putting this fund into segregation for minimum customer protection we were requiring the FCM's that were involved in the transactions incur financing costs, that is, that during the time period in which the option was outstanding, say six months or three months, they would have to carry the cost of carrying the premium over to England and at the same time, segregating some money in the United States and we fully anticipated that the carrying costs or the difference between what it would cost them to finance that and the amount they could receive as interest on the funds that were being put into segregation would probably we passed on to the customers as an additional customer charge. But in light of all the comments that we have received, we would suggest to the Commission that rather than trying to go into the question of what is the premium or defining the premium because what we really are talking about has nothing to do with the question of premium, particularly a premium that is put up in London or anyplace else. What we're really talking about is a minimal fund for customer protection. So to ameliorate the situation somewhat, what we would suggest to the Commission is that the segregation requirement be a reqirement of 90% of the amount that is put up by the customer be put into segregation and allow a 10% flow through to the FCM that is dealing with us.

Mr. Bagley: What was the basis, the exact arithmetic that you arrived at 90%?

Mr. Schneider: That's a hard question to answer. People

EXHIBIT IV

A-814

EXHIBIT IV TO MEMORANDUM

# MARKUPS AND NET INCOME BEFORE TAX AS A PERCENTAGE OF REVENUE

A Position Paper

Prepared by

National Association of Commodity Option Delaers
1666 K Street, N.W., Suite 700
Washington, D. C. 20006

December 2, 1976

## I. Data Sources:

1. "Cost of Doing Business - Corporations"; Key Business Ratios in 185 lines. Compiled by Dun & Bradstreet, Inc. (1973).

2. Almanac of Business and Financial Ratios, by Leo Troy, 1972 Edition, Englewood Cliffs, N. J.: Prentice-Hall, Inc. (1971)

## II. Definitions

For definitions, see Appendix A.

## III. Related Industries - Finance, Insurance and Real Estate

| | | | | SELECTED OPERATING EXPENSES | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ANCE, INSURANCE & REAL ESTATE | Total Number of Returns Filed | Cost of Goods Sold | Gross Margin | Compensation of Officers | Rent Paid on Business Property | Repairs | Bad Debts | Interest Paid | Taxes Paid† | Amortization Depreciation Depletion | Advertising | Pensio Other Employ Benef. Plans |
| | | % | % | % | % | % | % | % | % | % | % | % |
| tual Savings Banks | 467 | -- | -- | 1.82 | .33 | .14 | 3.54 | 72.32 | 1.97 | .76 | .85 | .77 |
| nks & Trust Companies, except tual Savings Banks | 14,663 | -- | -- | 5.75 | 1.71 | .45 | 4.04 | 39.59 | 2.70 | 2.47 | 1.29 | 1.70 |
| vings & Loan Associations | 5,887 | -- | -- | 3.05 | .43 | .36 | 6.58 | 68.44 | 1.71 | 1.15 | 1.71 | .57 |
| rsonal Credit Agencies | 15,556 | -- | -- | 2.57 | 2.39 | .25 | 8.10 | 30.04 | 2.75 | 1.12 | 2.35 | .69 |
| siness Credit Agencies | 3,073 | -- | -- | 1.82 | 1.23 | .52 | 2.65 | 35.96 | 1.52 | 7.66 | .51 | .97 |
| curity Brokers, Dealers & tation Companies | 3,312 | -- | -- | 11.58 | 3.46 | .25 | .42 | 10.22 | 2.98 | 1.01 | 1.39 | 1.83 |
| mmodity Brokers & Dealers, Security Commodity Exchanges, & Allied Services | 703 | -- | -- | 6.98 | 3.43 | .21 | .54 | 2.12 | 2.58 | 1.75 | 1.42 | 1.96 |
| e Insurance | 1,962 | 62.33 | 37.67 | .50 | .41 | .02 | .06 | .32 | 2.52 | .74 | .26 | .93 |
| e Insurance, Stock Companies | 1,600 | 59.37 | 40.63 | .78 | .38 | .01 | .12 | .33 | 2.53 | .55 | .29 | .65 |
| e Insurance, Mutual Companies | 170 | 64.81 | 35.19 | .26 | .43 | .02 | .02 | .31 | 2.51 | .91 | .24 | 1.15 |
| her Life Insurance Companies | 192 | 49.17 | 50.83 | 11.48 | 1.71 | .02 | .14 | .40 | 1.45 | .33 | .35 | 2.14 |
| tual Insurance, except Life or Marine, rtain Fire or Flood Insurance Companies | 940 | 66.50 | 33.50 | .46 | .46 | .01 | .11 | .06 | 2.70 | .43 | .45 | .52 |
| her Insurance Companies | 2,981 | 58.79 | 41.21 | .78 | 1.21 | .11 | .36 | 1.77 | 2.90 | .92 | .51 | .75 |
| surance Agents, Brokers & Services | 30,343 | 27.50 | 72.50 | 17.52 | 2.67 | .24 | .72 | 1.20 | 2.40 | 1.83 | 1.79 | 1.85 |
| al Estate Operators & Lessors, cept Developers | 195,793 | -- | -- | 2.58 | 3.82 | 3.46 | .35 | 19.82 | 15.33 | 17.19 | .62 | .17 |
| ssors of Mining, Oil & Similar Property | 1,985 | -- | -- | 1.05 | .34 | .21 | .28 | 13.75 | 4.37 | 48.41 | .02 | .22 |
| ssors of Railroad Property & al Property, Not Elsewhere Classified | 5,972 | -- | -- | 3.09 | 7.26 | 2.06 | .50 | 17.91 | 8.57 | 16.26 | .14 | .05 |
| bdividers, Developers & erative Builders | 46,192 | -- | -- | 9.35 | 1.95 | 1.42 | .76 | 15.97 | 6.86 | 4.99 | 3.06 | .72 |
| her Real Estate & Combination of al Estate, Insurance, Loan & Law Offices | 34,301 | -- | -- | 12.86 | 2.43 | .57 | .44 | 3.94 | 2.59 | 2.08 | 4.00 | 1.02 |

## IV. Other Selected Lines

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| rsonal Services | 36,584 | 54.60 | 45.40 | 7.38 | 4.22 | 1.32 | .33 | 1.11 | 3.57 | 4.48 | 1.62 | .68 |
| siness Services, except Advertising | 76,752 | 57.80 | 42.20 | 6.40 | 3.21 | .92 | .63 | 3.04 | 3.14 | 8.24 | 1.59 | 1.14 |
| ucational Services | 6,204 | 51.52 | 48.48 | 7.14 | 5.22 | .90 | .75 | 1.07 | 3.36 | 2.40 | 6.51 | .60 |
| lephone & Telegraph & Other mmunication Services | 2,873 | 48.72 | 51.28 | .23 | 1.14 | .63 | .44 | 4.55 | 7.71 | 11.33 | .45 | 4.43 |

## V. General Categories

|  | Total Number of Returns Filed | Cost of Goods Sold | Gross Margin | SELECTED OPERATING EXPENSES |  |  |  |  |  |  |  |  |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
|  |  |  |  | Compensation of Officers | Rent Paid on Business Property | Repairs | Bad Debts | Interest Paid | Taxes Paid† | Amortization Depreciation Depletion | Advertising | Pension / Other Employe Benefit Plans |
|  |  | % | % | % | % | % | % | % | % | % | % | % |
| DUSTRIAL GROUPS | 1.658,820 | 70.77 | 29.23 | 1.94 | 1.38 | .85 | .38 | 3.31 | 2.98 | 3.55 | 1.13 | 1.12 |
| RACT CONSTRUCTION | 127,670 | 82.97 | 17.03 | 3.33 | .53 | .57 | .19 | .72 | 1.92 | 1.90 | .20 | .71 |
| ILERS & WHOLESALERS | 524.586 | 77.44 | 22.56 | 1.86 | 1.42 | .31 | .22 | .75 | 1.40 | .92 | 1.02 | .35 |
| LERS | 351,819 | 72.55 | 27.45 | 1.88 | 2.08 | .38 | .24 | .81 | 1.60 | 1.09 | 1.51 | .37 |
| ESALERS | 172,149 | 83.16 | 16.84 | 1.82 | .64 | .23 | .20 | .67 | 1.16 | .71 | .43 | .33 |
| FACTURING | 202,102 | 70.31 | 29.69 | 1.13 | .92 | 1.32 | .19 | 1.42 | 3.16 | 3.76 | 1.37 | 1.50 |

## VI. Analysis of Markups and Profits

Based upon the ratios provided, it is easy to see that all industrial groups of firms (using a sample of 1,658,820) operate on a gross margin of 29.23% of Sales. This is equivalent to a 41.30% markup. Retailers (sample of 351,819) have a gross margin of 27.45% or a 36.43% markup on their costs of saleable merchandise. By normal rules of thumb, it would therefore not be unreasonable for commodity option firms to operate in the 36 to 41% markup range because they are really no different than any other retailers who purchase products from a wholesaler to sell to the public at a markup.

While there are few general differences between retailers of commodity options and merchants of any other product, we do know that while commodity option dealers are exposed to all of the normal risks of any retailer, such dealers have many, or even higher, risks and costs than the normal retailer, and should therefore be entitled to markups to help compensate for these unique costs.

The following is a partial list of costs and risks unique to commodity option dealers:

1. Commodity option dealers have tremendously expensive foreign communication costs unknown to most retailers.

2. The expenses of introducing a relatively unknown product into the market are far higher than selling a known product.

3. The extremely high startup costs for a new industry must be borne by each retailer. Under such conditions, each and every salesman and operating person must be trained by the employer since there is no pretrained pool of labor. And each potential customer must be educated before a selling process can begin. The education of sales and operating personnel as well as potential customers is a long, tedious and expensive process.

4. This industry is less than five years old and most firms operating in it are less than one year old. In 1974, 59.9% of all business failures occurred during the first five years of operation, and there is thus this risk and associated costs which can only be compensated for by higher markups.

We must therefore conclude that since commodity option dealers bear all of the normal risks associated with retailers, their markup on products must be at least equivalent. But since they are also subject to many additional risks and costs unknown to the mature retailer merchandising a known product to an educated population, the option dealer must be entitled to an even greater markup to compensate for these added uncertainties and expenses.

It therefore seems appropriate that a markup of 50% which is approximately 8% above the average markup of 1,658,820 firms used by Dun & Bradstreet in their statistical sampling work is more than justifiable, especially in light of the fact that the 41.30% average markup of these 1,658,820 firms is an "average" meaning that many of the firms contained in the sample have markups far in excess of this amount.

The following table shows only a small portion of the industry groupings which operate on a markup far in excess of the 41.30% normal for all industries, or the 50% believed to be reasonable for commodity option dealers:

| Industry | Number of Firms in Statistics | Average Markup |
|---|---|---|
| Eating & drinking places | 65,854 | 123% |
| Malt liquors & malt beverage industries | 65 | 100% |
| Tobacco manufacture | 101 | 69% |
| Photographic equipment & supplies manufacture | 459 | 121% |
| Hotels | 17,524 | 105% |
| Telephone & telegraph & other communication services | 2,873 | 105% |
| Crude petroleum, natural gas & natural gas liquids | 3,850 | 126% |
| Insurance agents, brokers & services | 30,343 | 264% |

Based upon using a markup of 50% for commodity option dealers, coupled with the average net profit before tax of 20.2% (calculated as a percentage of net revenue) earned by 1,139 commodity brokers and dealers, security and commodity exchanges and allied services (Appendix B), or the 21.2% net profit before tax for 2,249 security brokers, dealers and flotation companies (Appendix C), a net profit before tax of 10.10% to 10.60% of net revenue would place commodity option dealers in a similar profit position to commodity and security brokers who earn the 20.2 and 21.2% returns on gross revenue without having a cost of goods sold figure.

## VIII. Conclusion

Based upon the statistics presented, we must conclude that a markup on merchandise being retailed to the public of 50%, while slightly higher than the 41.30% average for all industries, is far lower than the rate used by many old-line categories of manufacturers, retailers and service firms and represents a rate of gross profit which barely compensates the firm in the commodity option field for the added costs and risks of pioneering and educating.

We must also conclude from the statistics, after making adjustments for the differences in accounting policies between security and commodity brokers who, by nature of acting as agent, have no real cost of merchandise to be sold and commodity option forms who can and do maintain inventories, that a pretax profit of 10.10 to 10.60% of gross revenue would make these firms competitive.

# *How to Use the Almanac of Business and Industrial Financial Ratios*

The *Almanac of Business and Industrial Financial Ratios* supplies you with the most complete, most recent corporate performance facts and figures currently available. To the users of financial and operating information — accountants, bankers, business managers, investment and management consultants, lawyers, credit executives, and trade association executives — the *Almanac* gives the answer to such practical and searching questions as:

Compared to the industry as a whole and also to corporations of similar size, how well is the company I am now studying performing in its ratio of Profit to Sales? On Net Worth? What about Costs? What percentage of Sales goes to Pensions and other Benefit Plans? How do the company's outlays on Compensation of Officers, Rents, Interest, Repairs, and Advertising compare with the competition? What about internal sources of capital? What share of Sales is going to Amortization, Depreciation, or Depletion? And what percentage of Net Income is held as Retained Earnings?

Based on the industry's record, the analyst can ask, are the company's capital allocations in line with competitors'?

The *Almanac* provides answers to these questions, and many others based on corporate activity in the United States as reported in the accounting period July 1968 through June 1969 — the most recent year for which authoritative figures derived from tax return data of the Internal Revenue Service are available.

Each industry is subdivided by asset size, as follows:

| | | | SIZE OF ASSETS IN THOUSANDS OF DOLLARS (000 OMITTED) |
|---|---|---|---|
| Total | *headlined in the charts as* | A. | Total |
| Under $50,000 | " " " " " | B. | Under 50 |
| $50,000 to $99,999 | " " " " " | C. | 50 to 100 |
| $100,000 to $249,999 | " " " " " | D. | 100 to 250 |
| $250,000 to $499,999 | " " " " " | E. | 250 to 500 |
| $500,000 to $999,999 | " " " " " | F. | 500 to 1,000 |
| $1,000,000 to $4,999,999 | " " " " " | G. | 1,000 to 5,000 |
| $5,000,000 to $9,999,999 | " " " " " | H. | 5,000 to 10,000 |
| $10,000,000 to $24,999,999 | " " " " " | I. | 10,000 to 25,000 |
| $25,000,000 to $49,999,999 | " " " " " | J. | 25,000 to 50,000 |
| $50,000,000 to $99,999,999 | " " " " " | K. | 50,000 to 100,000 |
| $100,000,000 and over | " " " " " | L. | 100,000 and over |

For each industry, the *Almanac* first provides the total number of returns (designated as "establishments" in the text) in each subdivision, the number without net income, and total receipts in millions of dollars. The 22 ratios and percentages which follow relate to *all* returns, those with and without net income.

The 22 ratios and percentages are given in three groups. All Operating Factors (numbers 4 to 15) are expressed as percentages of Net Sales. The percentages covered under Operating Factors are:

4. Cost of operations
5. Compensation of officers
6. Repairs
7. Bad debts
8. Rent on business property
9. Taxes (excluding Federal tax)
10. Interest
11. Depreciation/Depletion/Amortization (The most significant of these for each industry is indicated in a footnote to each table.)
12. Advertising
13. Pensions and other benefit plans
14. Other expenses
15. Net profit before Federal income tax

NOTE: For industries in Finance, Insurance and Real Estate, the operating factors are expressed as a percent of total receipts. This was necessary because companies in these industries receive their income from a number of sources rather than a predominantly single source such as Sales.

Items 16 through 21 are Financial Ratios, expressed as the number of times the first factor in computation is to the second. The method of computation of each ratio is explained in the following pages. The ratios given are:

16. Current ratio
17. Quick ratio
18. Net sales to net working capital
19. Net sales to net worth
20. Inventory turnover
21. Total liabilities to net worth.

Selected Financial Factors are given in items 22 through 25. These percentage relationships are as follows:

22. Current liabilities to net worth
23. Inventory to current assets
24. Net income to net worth
25. Retained earnings to net income.

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## SOURCES, DEFINITIONS AND EXPLANATIONS OF FACTORS AND RATIOS GIVEN IN THE ALMANAC

The source of all data used in the *Almanac* is the U.S. Treasury Department, Internal Revenue Service, *Corporation Source Book of Statistics of Income*. The definitions and significance of ratios and factors are explained below in terms of standard usage and the Internal Revenue Service's *Source Book*.

*Net sales:* The IRS' equivalent term, *business receipts*, is defined as gross receipts arising from the sale of goods or services from the principal business activity less allowances, rebates and returns.

*Total receipts:* Includes gross receipts and non-taxable interest received from state and local government obligations.

*Cost of operations:* The IRS term, *cost of sales and operations*, comprises direct costs incurred in providing goods or providing services, including costs of materials used in manufacturing, cost of goods purchased for resale, direct labor, and any operating expenses not separately identified in the corporation tax return.

*Compensation of officers:* The IRS includes in this term the amounts reported in the income statement of the corporation tax return or in supporting schedules of salaries and wages, as well as stock, bonuses or bonds, or other benefits, if identified as paid to officers for personal services rendered.

*Repairs:* This includes the cost of labor and supplies, and other costs necessary for incidental repairs to the property. Excluded are capital expenditures, improvements which appreciably prolong the life of the property, or expenditures for restoring or replacing property.

*Bad debts:* These include bad debts which occurred during the year, or a reasonable addition to an allowance or reserve for bad debts. For banks and domestic building and loan associations, corporate or government debt evidenced by certain bonds which became worthless were chargeable as bad debts. For other corporations, such losses were subject to the special capital gain on loss provisions of the law.

*Rent on business property:* In addition to rental payments, identifiable amounts of taxes and other expenses paid by lessees in connection with rents pair are included under their respective headings.

*Taxes:* These are state and local taxes or other deductible taxes paid or accrued on business property or incurred conducting business. This term includes Federal import and excise duties and taxes. Excluded are Federal income (or excess profits) taxes; income and profit taxes paid to a foreign country or possession of the U.S. if they were claimed as a credit against income tax.

*Interest:* Amount paid or accrued in connection with business indebtedness. For banks and saving institutions, the term includes interest paid on deposits and withdrawable shares.

*Depreciation:* A deduction from gross income of a reasonable allowance for the exhaustion, wear and tear, or obsolescence of property used in trade or business, or of property held for the production of income. The deduction is computed by a number of methods permissable by law.

*Depletion:* A deduction from gross income for the consumption of a wasting asset such as mineral deposit. There are two basic types of depletion allowances, cost and percentage, but no distinction between them is made in this publication.

*Amortization:* The IRS defines this to be the sum of deductions taken in lieu of depreciation for Goverment-certified emergency facilities for the national defense, and amounts of defense expenses written off for research and experimental expenditures, exploration and developmental expenditures, organizational expenditures and trademark, and trade name expenditures.

*Advertising:* These are expenditures directed to the sale of goods and services in the course of business activity. Amounts include advertising identified as a cost of sales or operations as well as advertising separately identified as a business deduction.

*Pensions and other benefit plans:* This item includes payments for pensions, profit-sharing, stock bonus, annuity or other deferred compensation plan payments by employers. The Internal Revenue Code imposes limitations on the amounts deductible for the taxable year and provides a carry-forward feature for certain amounts paid in excess of the limitation.

Also included are other employee benefit plans representing payments to employee death plans, health or accident and sickness plans, and other welfare plans.

*Other expenses:* This item includes contributions, business items not allocable to a specific deduction, and certain amounts which were given special treatment in the course of statistical processing by the IRS.

*Net profit before Federal income taxes:* These are net profits (*net income*) after deductions from *Net sales* or *Total receipts* of all expense items and before deduction of Federal income tax.

NOTE: Because the *Almanac* deals with *all* returns, those with and without income, a loss before tax in any industry, or asset size within an industry, is shown by an asterisk (*) at number 15 .This will explain those instances in which the sum of the operating factors exceeds 100.0%.

*Current ratio:* This is the relationship of current assets to current liabilities. It is an indication of the ability of the company to meet its current obligations.

Included in the computation were the IRS summaries of cash *plus* notes and accounts receivable, *plus* total inventories, *plus* investment in government obligations, *plus* other current assets, *less* reserve for bad debts.

Inventories are defined as goods on hand held for sale, and raw materials, or supplies which will physically become a part of merchandise intended for sale.

Included in the IRS' item, other current assets, were amounts reported as prepaid expenses, nontrade receivables, coupons and dividends receivable, claims and judgments, and similar items.

For current liabilities, we combined the IRS' items; accounts payable, mortgages, notes and bonds payable in less than one year, and other current liabilities.

*Quick ratio:* This is the relationship of cash, current receivables, and market-able securities to current liabilities. It indicates a company's ability to discharge current obligations without the necessity of selling off inventories.

*Net sales to net working capital:* This ratio indicates the amount of work in terms of sales performed by each dollar invested in working capital. Net working capital is the difference between assets and current liabilities.

*Net sales to net worth:* A ratio indicating the rate of turnover of the owner's investment.

*Inventory Turnover:* This is the cost of sales over average inventory which indicates the age and probable saleability of the inventory.

*Total liabilities to net worth:* This ratio indicates the degree of dependence on creditors, rather than owners, in providing funds for operating the business, or, in short, the amount of "trading on the equity."

Total liabilities consist of the items noted above in current liabilities, plus IRS items, loans from stockholders, mortgages, notes and bonds payable in one year or more, and other liabilities, less the cost of treasury stock.

Net worth consists of IRS items, capital stock, paid-in or capital surplus, surplus reserves, and earned surplus and undivided profits, *less* cost of treasury stock.

*Current liabilities to net worth:* A percentage indicating the extent to which current creditors are covered by the owner's investment.

*Inventory to current assets:* This percentage is an indication of the liquidity of the current assets.

*Net income to net worth:* This is the percentage rate of return received by the owners on their investment.

Net income is net after corporation income taxes and credits. It is obtained from net income before tax, including certain income from related foreign corporations (applicable only since January 1, 1963), *less* the sum of the current income tax and the tax from recomputing prior year investment credit, *plus* investment credit.

*Retained earnings to net income:* This is the percentage of earnings in the business. In certain cases this ratio may also reflect distributions from prior year's earnings, causing a negative ratio, and this is indicated by a minus sign (—) preceding the figure.

NOTE: If a percentage or ratio is less than one-twentieth of one percent (0.05%), or if the source data is incomplete, or if the factor is not applicable, a hyphen (-) is inserted in the text..

*ALMANAC OF BUSINESS AND INDUSTRIAL FINANCIAL RATIOS, 1972 EDITION*

## SECURITY AND COMMODITY BROKERS, DEALERS, EXCHANGES, AND SERVICES:

## Commodity brokers and dealers; security and commodity exchanges; and allied services

SIZE OF ASSETS IN THOUSANDS OF DOLLARS (000 OMITTED)

| Item Description (for accounting period 7/68 through 6/69) | A Total | B Under 50 | C 50 to 100 | D 100 to 250 | E 250 to 500 | F 500 to 1,000 | G 1,000 to 5,000 | H 5,000 10,000 | I 10,000 to 25,000 | J 25,000 to 50,000 | K 50,000 to 100,000 | L 100,000 and over |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Number of establishments | 1139 | 547 | 97 | 152 | 123 | 72 | 126 | 4 | 9 | 6 | 2 | 1 |
| 2. Number without net income | 347 | 250 | - | 39 | 32 | 1 | 23 | - | - | 2 | - | - |
| 3. Total receipts (in millions of dollars) | 402.4 | 20.8 | 9.6 | 15.5 | 19.0 | 20.6 | 148.4 | 7.8 | 48.8 | 40.1 | 67.6 | 3.6 |

### Selected Operating Factors in percent of total receipts

| Item Description | A | B | C | D | E | F | G | H | I | J | K | L |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 4. Cost of operations | .6 | 9.1 | - | - | 1.8 | - | - | - | - | - | - | - |
| 5. Compensation of officers | 15.3 | 46.5 | 3.4 | 34.4 | 18.1 | 17.0 | 19.7 | 14.5 | 7.8 | 7.8 | 2.4 | 4.4 |
| 6. Repairs | - | - | - | - | .9 | - | - | - | - | - | - | - |
| 7. Bad debts | - | - | - | - | - | - | - | - | - | - | - | - |
| 8. Rent on business property | 5.0 | 7.1 | 4.0 | 1.6 | 4.8 | 8.3 | 4.0 | 2.1 | 5.5 | 2.8 | 7.9 | .9 |
| 9. Taxes (excl Federal tax) | 3.6 | 2.7 | 2.0 | 4.6 | 2.6 | 2.3 | 2.7 | 3.8 | 4.2 | 4.4 | 5.7 | 5.8 |
| 10. Interest | 2.4 | - | - | - | 2.9 | 8.9 | .7 | - | 3.1 | 11.9 | - | - |
| 11. Deprec. Deplet/Amortiz† | 1.4 | 1.1 | 1.3 | .9 | 1.6 | 3.4 | 1.1 | .5 | 1.3 | 2.7 | 1.4 | - |
| 12. Advertising | 1.2 | - | .7 | - | 1.3 | 2.7 | 1.0 | .5 | 1.5 | .5 | 1.8 | - |
| 13. Pensions & other benef plans | 3.1 | - | - | 8.2 | 1.6 | .6 | 4.7 | 2.3 | 2.7 | 2.7 | 1.7 | .5 |
| 14. Other expenses | 46.8 | 37.2 | 71.1 | 29.3 | 56.1 | 22.5 | 49.1 | 28.4 | 48.0 | 38.0 | 57.3 | 33.4 |
| 15. Net profit before Tax | 20.2 | • | 17.2 | 20.6 | 8.0 | 34.1 | 16.6 | 47.9 | 25.3 | 28.9 | 21.5 | 54.9 |

### Selected Financial Ratios (number of times ratio is to one)

| Item Description | A | B | C | D | E | F | G | H | I | J | K | L |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 16. Current ratio | - | - | - | - | - | - | - | - | - | - | - | - |
| 17. Quick ratio | - | - | - | - | - | - | - | - | - | - | - | - |
| 18. Net sls to net wkg capital | - | - | - | - | - | - | - | - | - | - | - | - |
| 19. Net sales to net worth | 1.2 | 6.4 | 1.9 | 1.1 | .9 | 1.2 | 1.4 | 1.7 | 1.1 | 1.0 | 1.0 | 1.5 |
| 20. Inventory turnover | - | - | - | - | - | - | - | - | - | - | - | - |
| 21. Total liab to net worth | 3.2 | .7 | - | .7 | 1.1 | 1.8 | 1.5 | 6.1 | 1.6 | 4.5 | 1.3 | 182.3 |

### Selected Financial Factors in percentages

| Item Description | A | B | C | D | E | F | G | H | I | J | K | L |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 22. Current liab to net worth | - | - | - | - | - | - | - | - | - | - | - | - |
| 23. Inventory to curr assets | - | - | - | - | - | - | - | - | - | - | - | - |
| 24. Net income to net worth | 15.1 | 2.4 | 24.5 | 17.6 | 8.0 | 24.2 | 13.7 | 49.4 | 14.6 | 20.0 | 10.6 | 45.3 |
| 25. Retained earn to net inc | 77.4 | 100.0 | 100.0 | 96.7 | 96.9 | 100.0 | 65.7 | 52.6 | 67.8 | 65.0 | 100.0 | 100.0 |

†Depreciation largest factor

### ALMANAC OF BUSINESS AND INDUSTRIAL FINANCIAL RATIOS, 1972 EDITION

## SECURITY AND COMMODITY BROKERS, DEALERS, EXCHANGES, AND SERVICES:

## Security brokers, dealers, and flotation companies

| Item Description (for accounting period 7/68 through 6/69) | SIZE OF ASSETS IN THOUSANDS OF DOLLARS (000 OMITTED)<br>A<br>Total | B<br>Under 50 | C<br>50 to 100 | D<br>100 to 250 | E<br>250 to 500 | F<br>500 to 1,000 | G<br>1,000 to 5,000 | H<br>5,000 10,000 | I<br>10,000 to 25,000 | J<br>25,000 to 50,000 | K<br>50,000 to 100,000 | L<br>100,000 and over |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Number of establishments | 2249 | 725 | 184 | 286 | 162 | 210 | 473 | 68 | 73 | 26 | 17 | 25 |
| 2. Number without net income | 497 | 288 | 86 | 25 | 32 | - | 45 | 9 | 8 | 1 | 1 | 2 |
| 3. Total receipts (in millions of dollars) | 3302.2 | 77.6 | 11.6 | 32.3 | 28.9 | 93.7 | 386.9 | 200.4 | 340.1 | 260.3 | 290.8 | 1579.3 |
| Selected Operating Factors in percent of total receipts | | | | | | | | | | | | |
| 4. Cost of operations | - | - | - | - | - | - | - | - | 1.4 | - | - | - |
| 5. Compensation of officers | 10.4 | 8.7 | 19.2 | 19.7 | 23.4 | 30.8 | 15.3 | 15.4 | 14.9 | 10.8 | 9.0 | 6.2 |
| 6. Repairs | - | - | - | - | - | - | - | - | - | - | - | - |
| 7. Bad debts | - | - | - | - | - | 2.7 | - | - | - | - | - | - |
| 8. Rent on business property | 2.3 | 4.8 | 4.5 | 2.0 | 2.0 | 1.4 | 1.9 | 1.5 | 1.9 | 2.2 | 2.6 | 2.5 |
| 9. Taxes (excl Federal tax) | 3.2 | 3.1 | 2.2 | 2.9 | 3.3 | 4.0 | 3.6 | 3.0 | 3.6 | 2.6 | 3.3 | 3.0 |
| 10. Interest | 7.9 | 5.2 | 1.0 | .5 | 1.8 | 1.3 | 2.9 | 2.7 | 4.0 | 5.3 | 6.4 | 12.1 |
| 11. Deprec/Deplet/Amortiz† | .7 | 1.0 | 1.3 | .8 | 1.1 | - | .7 | .6 | .8 | .6 | .5 | .7 |
| 12. Advertising | 1.0 | .8 | 3.7 | .7 | .5 | .5 | .5 | 2.0 | 1.6 | .7 | .7 | 1.1 |
| 13. Pensions & other benef plans | 2.3 | 1.1 | 1.7 | 1.1 | 1.9 | 3.0 | 2.0 | 2.1 | 2.8 | 2.3 | 1.6 | 2.6 |
| 14. Other expenses | 50.2 | 61.2 | 70.7 | 61.0 | 43.2 | 25.0 | 43.5 | 45.9 | 42.2 | 53.3 | 60.8 | 52.5 |
| 15. Net profit before Tax | 21.2 | 13.8 | * | 11.3 | 22.6 | 31.0 | 29.1 | 26.2 | 26.3 | 22.0 | 14.6 | 18.8 |
| Selected Financial Ratios (number of times ratio is to one) | | | | | | | | | | | | |
| 16. Current ratio | - | - | - | - | - | - | - | - | - | - | - | - |
| 17. Quick ratio | - | - | - | - | - | - | - | - | - | - | - | - |
| 18. Net sls to net wkg capital | - | - | - | - | - | - | - | - | - | - | - | - |
| 19. Net sales to net worth | 2.1 | - | 1.2 | 1.4 | 1.0 | 1.3 | 1.5 | 1.4 | 1.8 | 2.4 | 3.0 | 2.5 |
| 20. Inventory turnover | - | - | - | - | - | - | - | - | - | - | - | - |
| 21. Total liab to net worth | 8.8 | - | .5 | .9 | 1.1 | 1.1 | 3.3 | 2.3 | 4.7 | 7.4 | 11.8 | 14.8 |
| Selected Financial Factors in percentages | | | | | | | | | | | | |
| 22. Current liab to net worth | - | - | - | - | - | - | - | - | - | - | - | - |
| 23. Inventory to curr assets | - | - | - | - | - | - | - | - | - | - | - | - |
| 24. Net income to net worth | 24.8 | - | 2.5 | 13.4 | 14.9 | 26.0 | 25.2 | 20.1 | 25.4 | 28.4 | 24.2 | 24.1 |
| 25. Retained earn to net inc | 90.5 | 41.3 | 100.0 | 96.9 | 100.0 | 93.5 | 96.6 | 85.6 | 94,7 | 90.8 | 97.1 | 88.6 |

†Depreciation largest factor

STATE OF NEW YORK )
COUNTY OF NEW YORK) ss.:

ROBERT LA GRASSA, being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 62-20 60th Rd. MASPETH, NYC.

That on the 26th day of JANUARY, 1977, deponent personally served the within JOINT APPENDIX (Volume II of II - Pages A-417 - A-825) upon the attorneys designated below who represent the indicated parties in this action and at the addresses below stated which are those that have been designated by said attorneys for that purpose.

~~By leaving ______ true copies of same with a duly authorized person at their designated office.~~

By depositing 1 true/~~copies~~ copy of same enclosed in a postpaid properly addressed wrapper, in the post office or official depository under the exclusive care and custody of the United Stated post office department within the State of New York.

Names of attorneys served, together with the names of the clients represented and the attorneys' designated addresses.

HOWARD SCHNEIDER, ESQ.
General Counsel
Commodity Futures Trading Commission
Attorney for Defendants-Appellees
2033 K Street, N.W.
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LEONARD GOLDSTEIN, ESQ.
Goldstein, Ahalt & Bennett
Counsel for other Plaintiffs-Appellants
4321 Hartwick Rd.
College Park, Maryland

Robert La Grassa

Sworn to before me this

26th day of JANUARY, 1977.

Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 1977